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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR PETITIONER, TEXAS GAS TRANSMISSION CORPORATION

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BRIEF FOR PETITIONER TEXAS GAS TRANSMISSION CORPORATION

OPINIONS BELOW

The initial opinion of the Court of Appeals (FPC Pet. 17-39) and its opinion on rehearing (FPC Pet. 41-53) are reported at 462 F.2d 853, 865. The initial opinion (Opinion No. 578) of the Federal Power Commission (R. 100-111), and its opinion on rehearing (Opinion No. 578-A, R. 145-149) are reported at 43 FPC 824 and 44 FPC 140, respectively.

JURISDICTION

The judgment of the Court of Appeals was entered on February 18, 1972 (FPC Pet. 55-56). Petitions for rehearing filed by the Commission and Texas Gas Transmission Corporation (Texas Gas) were denied on May 11, 1972. The petition for a writ of certiorari was filed in this case on September 23, 1972, within the time for filing such petitions as extended by order of the Chief Justice dated August 4, 1972. The petition for a writ of certiorari in this case was granted on December 4, 1972. The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, *et seq.*, 26 U.S.C. § 167(1) are set forth at FPC Pet. 73-78.

QUESTION PRESENTED

Whether Congress intended by Section 441 of the Tax Reform Act of 1969, to withdraw from the Federal Power Commission (and other agencies charged with similar regulatory responsibilities) the authority and discretion to permit a utility to change, for rate-making purposes, its method of tax depreciation for existing and new non-expansion properties from liberalized depreciation with flow-through (1) to liberalized depreciation with normalization or (2) to straight-line depreciation.[1]

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[1] As used in this brief, the term "existing property" means "pre-1970 property", "new property" means "post-1969 property" and "expansion property" means post-1969 property which "increases the productive or operational capacity of the taxpayer • • • and does not represent the replacement of existing capacity" as defined in Section 441(a) of the 1969 Tax Reform Act.

STATEMENT

Background

Prior to the enactment of Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, the utilities had generally used the straight-line depreciation method for determining federal income tax expense. Under this method, annual depreciation is uniform over the asset's life. Section 167 authorized taxpayers to compute tax depreciation, in addition to straight-line, by one of several accelerated or "liberalized" depreciation methods. Under any of these liberalized methods, annual depreciation is higher in the asset's early years and lower in its later years than under the straight-line method, and conversely, the federal income tax payment is lower in the early years and higher in the later years. Under all the depreciation methods here involved—straight-line and liberalized—the aggregate tax depreciation over the life of an asset never exceeds its total depreciable value.[3]

In enacting Section 167, the Congress intended to increase available working capital for all segments of the American economy to assist in the modernization and expansion of industrial capacity. H. Rep. 1337, 83d Cong.; S. Rep. 1662, 83d Cong., *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 316 F.2d 659, 662 (D.C. Cir. 1963).

In the early years following the enactment of Section 167, the Commission determined that the use of liberalized depreciation resulted in a tax deferral, and that the income tax expense allowed in the cost of service should be "normalized" for rate purposes,

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[3] There is no question here with regard to book depreciation which still is largely determined on the straight-line method.

i.e., the income tax allowed should be computed on the basis of straight-line depreciation and the difference between the taxes thus computed and the actual taxes payable under liberalized depreciation should be kept in a reserve account to be available, as needed, to pay the higher income taxes of later years. See, *e.g.*, *Amere Gas Utilities Co.*, 15 FPC 760, 781 (1956). In so doing the Commission reasoned that present rate payers would not benefit at the expense of future rate payers, and *vice versa*. This Commission position was affirmed by the Fourth Circuit as being a matter within the Commission's special expertise. See, *e.g.*, *City of Lexington* v. *F.P.C.*, 295 F.2d 109, 114 (4th Cir. 1961).

Several years later (1964), after its membership had changed substantially, the Commission (3-2) reversed this earlier decision by finding that the utilization of liberalized depreciation generally resulted in a permanent tax savings and directed that these "savings" should "flow-through" to the customers, in the form of reduced rates by computing income tax allowances on the basis of liberalized depreciation. *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 (1964) affirmed *sub nom.*, *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F.2d 318 (5th Cir., 1966) *cert. denied* 385 U.S. 847 (1966).

Two years later (1966), the Commission (3-2) decided that, for rate purposes, it would impute the use of liberalized tax depreciation to any company which shifted from liberalized depreciation to straight-line depreciation and would flow through the resulting imputed tax "savings" to the rate-payers. See *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), affirmed, 388 F.2d 444 (7th Cir., 1968), *cert. denied*, 392 U.S. 928 (1968).

The courts, in all three cases, recognized that the regulation of the tax depreciation policies followed by jurisdictional companies for rate purposes lay within the Commission's discretion.[3]

As we will show below, with the passage of the Tax Reform Act of 1969, a vital premise of the Commission's flow-through policy disappeared; the tax reduction ceased to be a "saving" and became a mere deferral.

Section 441(a) of the Tax Reform Act of 1969

As shown in detail, *infra*, pp. 42-51, the legislative history as well as the language of Section 441(a) establish the serious concern which the Congress had, over the loss of tax revenues as a result of the actions taken, or threatened, by regulatory agencies in the rate treatment of liberalized depreciation. (H. Rep. No. 91-413, Part I, 91st Cong., 1st Sess., p. 132; App. A, *infra*, p. 78).[4] In order to forestall this continuing loss of tax revenues, the House Ways and Means Committee proposed and the House adopted the following three general rules (*id.* at 133):

> "(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

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[3] The Commission has consistently regarded the treatment of liberalized depreciation in a regulatory context as a matter of administrative discretion. See, *e.g.*, *Alabama-Tennessee Natural Gas Co.*, 31 FPC at 216; *Natural Gas Pipeline Co.*, 33 FPC 574, 578 (1965), vacated on other grounds *sub nom. City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied sub nom. P.S.C. of Wisconsin* v. *F.P.C.*, 390 U.S. 945 (1968).

[4] In view of their importance to the proper disposition of this proceeding, we have reproduced for the Court's convenience in Appendices A, B and C hereto, the entire discussion of tax depreciation for regulated utilities in the reports of House, Senate and Conference Committees, respectively.

"(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

"(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

As also shown in detail, *infra*, pp. 16-27, the Senate Committee adopted the same three general rules, and provided, in addition, a *supplemental*[5] privilege to regulated utilities by way of an election, with respect to *existing* as well as *new* property, which was not available under the House version (see S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 172-173; App. B, *infra*, pp. 82-83). As further shown, *infra*, pp. 28-32, the Conference Committee made no changes in the general rules. However, it did revise the election provided in the Senate bill to exclude existing properties entirely and new properties other than expansion property from its coverage. See H. Rep. No. 91-782, 91st Cong., 1st Sess., pp. 312-313, App. C., *infra*, pp. 90-91.

The Proceedings Before the Commission

Prior to the enactment of the Tax Reform Act of 1969, Texas Gas, like most of the utilities regulated by the Commission, and under compulsion of *Alabama-Tennessee* and *Midwestern, supra,* was utilizing liberalized depreciation with flow-through. Also prior to the passage of the Tax Reform Act, Texas Gas filed, pur-

[5] Emphasis supplied throughout unless otherwise indicated.

suant to Section 4(e) of the Natural Gas Act 15 U.S.C. § 717c(e), a proposal to increase its rates which *inter alia* would permit it to recover the increased taxes associated with its request to return to a straight-line method of tax depreciation with respect to *all* of its qualified property. (R. 1399).

After the passage of the Tax Reform Act and during the course of the above described rate proceeding, Texas Gas advised the Commission of its intent to exercise the election provided in Section 441 and to use, with Commission permission, liberalized income tax depreciation with normalization for its *expansion* properties. However, Texas Gas requested Commission assurance, before it made the election, that it would be permitted to change to straight-line, or alternatively and preferably, to normalization for its *existing and new non-expansion* properties. If it made the election without such assurance, the Company urged, it would be confronted with a continual loss of income tax depreciation deductions, necessitating further and repeated applications for rate increases (R. 2694-5).

In May, 1970, the Commission issued Order No. 404, 43 FPC 740, announcing its intention to permit companies subject to its regulation, which invoked the election, to use liberalized depreciation with normalization for the expansion properties.

In Opinion No. 578, issued on June 3, 1970, the Commission granted the Company permission to shift to normalization for the rest of its properties (R. 100-111).[6] The Commission pointed out that its premise in *Alabama-Tennessee, supra*, that the use of liberalized depreciation resulted in permanent tax savings for

[6] *I.e.*, existing properties and new non-expansion properties.

companies with growing or stable plant, was no longer valid for companies, such as Texas Gas, which had elected to abandon flow-through for their expansion properties (R. 108). As a result, the Commission found that requiring Texas Gas, nevertheless, to continue to use flow-through for its existing and new non-expansion properties would result in the Company's tax component increasing constantly with a resulting continual need for increased rates (R. 108, 110).

Accordingly, the Commission concluded that permitting Texas Gas, in such circumstances, to shift to normalization for its existing and new non-expansion properties offered "more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases" (R. 109). In addition, the Commission required Texas Gas to place the difference between the taxes due and the taxes allowed as a result of using normalization in a special reserve which would be excluded from the rate base on which the return allowed is computed with the result that the consumers would share in the benefits of normalization (R. 111).

Thereafter, on June 8, 1970, Texas Gas exercised its election not to have flow-through apply to its expansion property and commenced normalization of the tax expenses on all of its utility property as of January 1, 1970. The normalized taxes have been collected in Texas Gas' rates since January 12, 1970.

The Decision of the Court Below

The court below affirmed the Commission's action in Order No. 404 permitting companies on flow-through to use normalization for expansion properties (FPC

Pet. 20-29).[1] However, it set aside the Commission's action in Opinion No. 578 permitting Texas Gas to change to normalization for its existing and new non-expansion properties holding that Texas Gas ". . . is specifically prohibited, under the final version of the bill . . ." from abandoning flow-through (FPC Pet. 34). This is the keystone finding of the court's conclusion. It is based upon the premise that, by virtue of the revisions proposed by the Senate and Conference Committees, the final version of the Tax Reform Act of 1969 withdrew from the Federal Power Commission (and other regulatory agencies) once the 180-day period of the election had expired, the power and discretion to permit a regulated utility to switch from flow-through to either normalization or straight-line depreciation with respect to any of its properties for rate-making purposes.

SUMMARY OF ARGUMENT

I.

A. The Court below recognized that "the Commission and Texas Gas' position here [was] clearly justified" under the third general rule as recommended by the House Committee and adopted by the House. However, it held that the Senate Committee intended to replace that rule with a right of election. But, in so holding, the Court erred by ignoring the express adoption by the Senate as a "committee amendment", of a rule virtually identical in language to the House's third rule. The only significant difference between the two is the inclusion in the Senate version of the paren-

[1] This Court has denied certiorari on October 16, 1972, No. 72-96; 93 S. Ct. 234.

thetical phrase "except as provided under the Committee's amendment discussed below".

However, when read in light of the sentence structure and punctuation, this phrase plainly was intended to refer to an *additional* means (i.e., the right of election) by which a taxpayer could discontinue the use of flow-through. This reading is buttressed (1) by the Senate Committee's discussion of the application of a comparable rule to new properties and (2) by the identity in the Senate and House Committee's estimates as to the revenue increases expected to result from those amendments, exclusive of the right of election.

The Court compounded this error by focusing its consideration of the Senate version entirely upon that Committee's discussion of the proposed election. The Court was misled by the apparent overlap between the third rule and the right of election, since under both, a company on flow-through needs agency permission to change to normalization. However, the right of election has a different operational impact than the third rule, and of course, operates in a different time period, i.e., 180 days for the right of election as compared to an indefinite period with respect to the third rule. Thus, there is no overlap and there is no reason why the two cannot co-exist as intended by the Senate Committee.

B. Likewise misplaced is the Court's reliance upon the Conference Committee's report as support for its result. Not only was there no disagreement between the two Houses to be resolved by the Conference Committee, but the language of that Committee's report, relied on by the Court below, does not provide the sup-

port which the Court purported to see in it. In contrast, the Conference Report is completely silent on the matter, and since several members of the House Committee were very upset about the revenue losses resulting from the use of flow-through, it is difficult to believe that, as House conferees, they would have agreed to "freeze" companies on flow-through to that method, let alone that they would refrain from discussing such an agreement, if it existed, in the Conference report.

That the bill, as enacted, included the third general rule as well as the election as limited by the Conference Committee is also clear from the General Explanation of the 1969 Tax Reform Act subsequently prepared and issued by the Joint Committee Staff. The Court's various aspersions upon this document fall short of the mark; read with an acceptance of the coexistence of the third general rule and the right of election, the General Explanation is clear and wholly devoid of confusion and uncertainty.

II.

A. The Court of Appeals' holding derives no support from the Congressional purposes in enacting Section 441. Contrary to the Court's ruling, the fact that Congress intended a "freeze" generally with respect to methods of tax depreciation does not mean that Congress intended thereby to bar regulatory agencies from permitting companies on flow-through to change to other methods of tax depreciation. The Court's heavy reliance in this regard upon the House Report is misplaced since that report also admittedly contains the third general rule. Moreover, it misreads the nature of the "freeze" itself, which is built into the

three general rules and constitutes the Congressional resolution of a dilemma.

On the one hand, the revenue losses resulting from the trend among regulatory agencies to require companies to change to depreciation with flow-through was a matter of grave concern to the Committee. As far as the Committee was concerned, the rate reductions resulting from these trends constituted an anticipated and unwarranted "subsidy" for the rate payers at the expense of the taxpayers. On the other hand, they recognized the unsoundness of adopting the recommendation of the Federal Power Commission that all regulated companies be required to revert to straight-line depreciation since it would place many of these companies at a disadvantage competitively with other, particularly unregulated, companies.

To resolve the dilemma, Congress adopted the three general rules. On the one hand, they imposed a freeze by prohibiting a company from changing to *faster* methods of tax depreciation, thereby forestalling any increase in the tax revenue losses. On the other hand, the three rules do not impose any statutory barrier to changing to *slower* methods of tax depreciation, thereby providing the leeway needed to protect the competitive position of regulated companies while, at the same time, keeping the way open for reduction in revenue losses through changes to slower methods of tax depreciation.

In contrast, the Court's version of the Congressional resolution of this dilemma would destroy flexibility and ability to accommodate to changing conditions. It would prevent the reduction in tax revenue losses which would come about when a company on flow-

through changes to a slower method of tax depreciation. And it would perpetuate the very type of tax revenue loss which the Act's legislative history plainly discloses was obnoxious to many of the responsible members of Congress.

B. Contrary to the implication of the Court below and the explicit contention of respondent Memphis, Congress fully recognized that rate increases would be necessary to reflect changes to slower methods of tax depreciation. The Summary prepared by the Joint Committee Staff cited by the Court below and Memphis is entirely irrelevant, since it relates solely to the bill as it passed the House of Representatives. The House bill is different from the bill as passed by the Senate and from the bill as finally enacted in the critical respect that the latter bills contained an added right of election to change from flow-through to other methods of tax depreciation, a right, limited in the final bill, to new expansion properties.

The exercise of this election, as added by these later bills, as the Commission found, did away with the tax savings needed to avoid the future repayment of taxes avoided earlier by utilizing liberalized depreciation. The legislative history shows that Congress was fully aware that the wiping out of the benefits of such "tax reductions, tax savings," (House Hearings, p. 3569) would create a need for rate increases to offset the loss of these benefits.

III.

The Commission's action in permitting Texas Gas to change from flow-through to normalization for its existing and new non-expansion properties is well

within the Commission discretion, which under established precedents, is extremely broad, particularly with regard to such technical matters involving Commission expertise.[8]

Since the Commission decision in *Alabama-Tennessee, supra*, holding that the use of liberalized depreciation results in a tax savings, there have been at least two dramatic changes in circumstances. First, a critical shortage of natural gas has developed, which undercuts the *Alabama-Tennessee* finding that the natural gas industry will be growing, or at least a stable industry, for the indefinite future. Second, Texas Gas' exercise of the right of election has the effect of rendering the tax depreciation in the new expansion facilities no longer available to offset the declining tax depreciation on the older facilities, as contemplated in *Alabama-Tennessee.*

In addition, the Commission found and the evidence shows, that normalization would help stabilize Texas Gas' rates and would enhance the quality of its securities. Accordingly, it is apparent that the Commission decision is amply supported.

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[8] We read the decision of the court below as holding that, if the Federal Power Commission retained discretion under the Tax Reform Act of 1969 to permit a utility to change its method of computing tax depreciation from liberalized depreciation with flow-through to a slower method for rate purposes, then the proposal of Texas Gas was clearly justified. Our discussion of the Commission's exercise of its discretion in this brief is presented in order to avoid a remand to the court below should this Court disagree with that reading of the decision below.

ARGUMENT

I.

SECTION 441 OF THE 1969 TAX REFORM ACT DOES NOT BAR THE COMMISSION FROM PERMITTING COMPANIES ON FLOW-THROUGH TO CHANGE TO OTHER METHODS OF TAX DEPRECIATION FOR THEIR EXISTING AND NEW NON-EXPANSION PROPERTIES

In holding that Congress intended Section 441 of the 1969 Tax Reform Act to preclude regulatory agencies from permitting regulated utilities such as Texas Gas to change from flow-through to other methods of tax depreciation for their existing and new non-expansion properties, the Court of Appeals expressly recognized that "The Commission's and Texas Gas' positions here [was] clearly justified" under the third general rule as provided in the House bill (FPC Pet. 32),[9] and based its contrary holding primarily on its reading of the Senate and Conference Committee versions of that section.[10] We show below that the Court's

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[9] As recognized by the Court below (FPC Pet. 31-32), the third general rule provided in the House Bill would have been applicable to utilities such as Texas Gas which had been taking liberalized depreciation and flowing the benefits thus deferred through to its customers. By providing in the third general rule that companies on flow-through must continue to use flow-through "unless the appropriate regulatory agency permits a change as to that property" (See *supra*, p. 6), the House Committee makes clear its intent that changes by a company on flow-through to other methods of tax depreciation may be made but are subject to the approval of the regulatory agency involved.

[10] The Court explained its total reliance upon legislative history with the comment that "the intent of Congress is not readily apparent on the plain face of this statute" FPC Pet. 51 fn. 8. However, as summarized in the Court's main opinion (FPC Pet. 30-31):

> "• • • Under Section 441(a), a 'reasonable allowance' may be computed in either of two ways: one, a 'subsection (1) method,' refers to the straight-line method of depreciation,

reading of those Committee versions is grossly in error and that, in fact, they did not change or modify the third general rule as provided by the House Committee and adopted by the House.

A. The Senate Committee Did Not Intend To Replace the House's Third Rule with a Limited Election

Rejecting the contention that the Senate had intended the right of election as an addition to, not a replacement for, the third general rule provided by the House, the Court below in its original opinion, held that the bill recommended by the Senate Finance Committee and passed by the Senate struck out the House's third general rule and substituted in its stead with respect to existing and new properties (FPC Pet. 32-33):

> "* * * an election to be made within 180 days after the date of enactment of the bill for a utility * * * to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method * * *."

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while the other is 'the applicable 1968 method for such property' but 'only if the taxpayer uses a normalization method of accounting.' (fn. omitted.) Section 441(a), however, provides an exception to the normalization requirement for using the second method by allowing a utility using the flow-through method to continue doing so."

While the *full* impact of these provisions may not be crystal clear upon a first reading, it is readily apparent upon careful consideration that the three rules are included within the above description, particularly in light of the "may" language used in the statute in referring to companies on flow-through (See FPC Pet 73) and the past recognition that the question of the appropriate method of tax depreciation is a matter of Commission discretion. See *supra*, pp. 4-5. In addition, of course, these provisions are separate and distinct from the right of election which is set out in Section 441(a)(4)(A). In any case, as we show in detail in the text, the Court's reading of the legislative history, on which it places primary reliance, likewise does not support its result.

Continuing, the Court below reasoned that since the Conference Committee limited the 180-day election to expansion properties, the result was entirely to bar the Commission (and other regulatory agencies) from permitting companies subject to its jurisdiction from thereafter changing from flow-through to other methods of tax depreciation for their other properties (FPC Pet. 34).

Seeking further to buttress this conclusion, the Court of Appeals, in its opinion on rehearing, undertook to chart its view of the revisions in the legislation as it made its way through Congress (FPC Pet. 44), and insisted that there was "no language to the contrary" to refute its result that "the Senate limited * * * *all* changes re both expansion and non-expansion property to a 180-day election period." (Emphasis in original.) (FPC Pet. 43-45).

It is our position not only that there was "language to the contrary," in the report of the Senate Committee but that that language, properly read and construed, discloses, beyond any possible doubt, that the Senate Committee intended the 180-day election to be an *addition* to—not a *replacement* for—the House's third general rule.

1. The Court Below Ignored the Language in the Senate Committee Report Clearly Including an Acceptance of the House's Third General Rule

To begin with, the Senate Committee Report explicitly states (S. Rep. No. 91-552, *supra*, at pp. 172-173, App. B, *infra*, pp. 82-83):

> "*Both* the House bill *and* the committee amendments provide that in the case of existing property,[11] the following rules are to apply:
>
> * * * *

[11] While our argument is formulated in terms of "existing property", it applies equally to the new non-expansion properties.

> "(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the Committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property."

The use of the conjunctions "both * * * and" in the above excerpt plainly evidences the intent of the Senate Committee to prescribe the same third general rule as provided in the House bill.[12]

In addition, the formulation of that rule as set out in the Senate Committee Report is itself virtually identical to the third rule contained in the House Committee report (H. Rep. No. 413, *supra*, at 133, App. A, *infra*, p. 79):

> "(3) If the taxpayer is taking accelerated deprecation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

The only significant difference between the two formulations is the inclusion of the parenthetical phrase "except as provided under the Committee amendments which are discussed below" in the Senate Committee's version. However, this parenthetical reference to the right of election added by the Senate Committee obviously does not manifest an intent to eliminate the applicability of the remainder of the entire text em-

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[12] There is no question but that the first two rules set out in the Senate Report track those proposed by the House Committee and adopted by the House.

bodying the third general rule proposed by the House and not included within the parenthesis.

To support such a result, it would be necessary for the parenthetical phrase to be read as being intended somehow to wipe out the clause "unless the appropriate regulatory agency permits a change as to that property" following after the parenthesis. But the position of the parenthetical phrase in the sentence (i.e., immediately before the "unless" clause), together with the comma separating the parenthetical phrase from the following "unless" clause, plainly belies the validity of any such construction.

Rather, read as indicated by (1) the sentence structure, (2) the presence of the limiting "except" in the parenthetical phrase, and (3) the comma separating the parenthetical phrase from the following clause, it is clear that the parenthetical phrase is intended to modify the clause "then the taxpayer would continue to do so" immediately preceding the parenthesis. So read, the parenthetical phrase serves to refer to a method being added by the Senate Committee under which the taxpayer would not have to "continue to do so", i.e., would not have to continue on flow-through. In other words, the parenthetical phrase is intended to indicate a method, *in addition to* that provided by the "unless" clause, by which a taxpayer on flow-through could change to other methods of tax depreciation.

That such reading of the parenthetical phrase conforms to the intent of the Senate Committee is reinforced by that Committee's proposed tax depreciation treatment for *new* properties of companies on flow-through. Thus, immediately following the language

just discussed relating to existing properties, the Senate Committee Report states (S. Rep. No. 91-552, *supra*, at p. 173; App. B, *infra*, p. 83):

> "Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies) * * *."

The reference to "both versions" and the use again of the limiting "exception" language in the parenthetical clause serve to emphasize the primary intent of the Senate Committee to track the general rule for such new property as adopted by the House. In addition, it should be noted that while the parenthetical "unless" clause in the above excerpt comes after the non-parenthetical "unless" clause, any problem whether the parenthetical clause was in substitution for or in addition to the other clause is entirely eliminated by the use of the parallel "unless" structure in both clauses and the coupling of the two clauses by the disjunctive "or".

Thus, the discussion relating to new property makes it plain that the Senate Committee intended the right of election as an additional, not a substitute, method by which companies on flow through and not exercising the 180-day election could shift to other methods of tax depreciation for such properties. And since the Senate Committee proposed that companies on flow-through should have the same right of election for their existing properties as well as for their new prop-

erties, the fact that the election for new properties was clearly in addition to, not a replacement for, the general rule, strongly supports the same result with respect to existing properties.

Finally, it should be noted that the revenue increases resulting under the Senate version of Section 441, apart from those brought about by the exercise of the right of election, are exactly the same as those estimated by the House Committee. Thus, the House Committee report states (at p. 134, App. A, *infra*, p. 80):

> "The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974 and $310 million in 1979,"

and, in like manner the Senate Committee report states (at p. 176, App. B, *infra*, p. 89):

> "The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election."

Certainly, if the Senate Committee had intended for the right of election to replace the third general rule, it would have reduced its estimate of revenue increases to reflect the effect of the reduction in shifts to slower methods of tax depreciation. The facts (1) that the Senate Committee used the same estimate of revenue increases as the House and (2) that it treated the revenue increases expected under the right of election

separately, operate further to demonstrate that the Senate Committee intended the same three substantive rules to be applicable, with the right of election being an addition to, and not a replacement of, the third rule.

2. The Court Below Improperly Focused Upon the Language in the Senate Report Dealing With the Proposed Election

In reaching its conclusion that the Senate Bill replaced the third general rule with the right of election, the Court below completely ignored the clear statements in the Senate Committee Report. Instead, it focused its entire attention upon the language in that report dealing with the proposed election. This is apparent from the following excerpt from the Court of Appeals' main opinion, which consists of its entire discussion of the Senate Committee Report on this aspect of the case (FPC Pet. 32):

> "The bill as reported by the Senate Finance Committee gave regulated utilities using liberalized depreciation with flow-through an election to abandon that method of depreciation both for 'pre-1970' property (a change from 'existing' property in the House version) and 'post-1969' property ('other' property in the House bill). The Senate Report states in regard to the altered right of election:
>
> 'The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the regulatory agency, or permit it with the permission of the regulatory

agency to shift to the normalization method (that is, to come under general rules of the bill). This election applies both as to new and *existing* property.' (footnote omitted).

"Under the Senate version of the bill, therefore, Texas Gas would have been permitted to shift from liberalized depreciation with flow-through either to straight-line depreciation, or, with the FPC's approval, to liberalized depreciation with normalization." (Emphasis in original).[18]

The Court's opinion does not disclose its reasoning or justification for thus focusing upon the Senate Committee's discussion of the right of election to the exclusion of that Committee's discussion of the third general rule. Consequently, one can only speculate as to its rationale for concluding that the Senate Committee intended the election to be a substitute for, rather than an addition to, the third general rule. However, it would appear that the Court was misled by an apparent overlap between the third general rule, on the one hand, and the proposed election, on the other.

This apparent overlap stems from the fact that under both the third general rule and the right of election, a company on flow-through needs agency permission to change to normalization; the only difference between the two appears to be one of duration—the election has a 180-day life, whereas the third general rule continues indefinitely. No such apparent overlap exists, however, with respect to changes to straight line de-

[18] The Court's opinion on rehearing casts no additional light. Its sole discussion of this problem is a reference to the "analysis" in its main opinion. See FPC Pet. p. 43.

preciation; under the election, a company on flow-through can change to straight line depreciation with or without agency permission whereas, under the third general rule, such a company needs agency permission to make such a change.[14]

But, contrary to the assumption of the Court below, the two parts of the proposed election were not intended as separate and distinct from each other with each having a counterpart, either the same or different, in the third general rule. Thus, the right to change to straight line depreciation in the election, with or without agency permission, was not intended as a revision of the provision in the third general rule permitting such a change to straight line depreciation only with agency permission. Likewise, the provision in the election permitting changes to normalization with agency permission only for a 180-day period was not intended as a revision of the provision in the third general rule permitting such change to normalization without time limit. Rather, the two parts of the election were collectively intended as mutually interdependent aspects of a single package. The two parts of the election, taken together, have an operational impact different from the two parts of the third rule. Hence, they were

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[14] That this apparent overlap between the third general rule and the proposed election in fact underlies the Court's approach is indicated by the observation in the Court's opinion on rehearing that FPC Pet. 43-45):

> "Thus, between the initial House and Senate versions of Section 441(a), two differences emerge with respect to Situation III [flow-through] and to shifting from flow-through: First, under the Senate version, in contrast to the House, FPC approval is *not* required to shift from the flow-through to the straight-line method; and second, the Senate limited * * * *all* changes re both expansion and non-expansion property to a 180-day election period." (Emphasis in original).

designed to confront the regulatory agency involved with different situations in the different time periods in which they were operative.

Thus, the provision in the election that a company on flow-through could change to straight line depreciation without agency permission during the 180-day life of the election (1) assured a company on flow-through that it could change to another method of tax depreciation during the 180-day life of the election and (2) was designed to put pressure upon the regulatory agencies when confronted with the problem during that period more freely to grant to such a company permission to change to normalization. As occurred in the related Texas Gas proceeding, Texas Gas elected to change to straight-line depreciation during the 180-day life of the election without Commission permission with respect to its new expansion properties; however, since it preferred changing to normalization, it left it up to the Commission whether to permit it to change to normalization as an alternative to changing to straight-line depreciation. Since the Commission also regarded the change to normalization as preferable to straight-line depreciation, it gave Texas Gas permission to change to normalization with respect to those properties. See FPC Order No. 404, 43 FPC 740 (1970), *supra*, p. 7.

The third general rule requiring agency permission before a company on flow-through could change either to straight-line or normalization has no such operational effects. Under this rule, which is to remain in effect without time limit, companies on flow-through had no assurance that they would be permitted to change to another method of tax depreciation. Nor were the regulatory agencies subject to any legislative pressure

to permit any such change to another method of tax depreciation. Whether a company on flow-through could change to another method of tax depreciation and whether such change, if permitted, was to straight-line depreciation or normalization, were matters left for determination by the regulatory agency as an exercise of its discretion in the particular circumstances involved.

In view of these differences in operational effects and the election's 180-day *limited* life as compared to the *indefinite* life of the third general rule,[15] there is in fact no overlap between the election and the third general rule, and, contrary to the Court below, the Senate Committee did not intend the election to be treated as a substitute for, rather than as an addition to, the third general rule.

B. The Conference Committee Did Not Modify the Third General Rule

1. There Was No Disagreement with Regard to the Third General Rule Between the House and Senate Bills to be Resolved by the Conference Committee

The Court's further assumption that its conclusion was supported by the report of the Conference Committee is based primarily on its earlier conclusion that there was a disagreement between the House and Senate versions of the proposed legislation. According to the Court, since the Senate had replaced the House's third general rule with a 180-day election applicable to new and existing properties, the Conference Committee

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[15] Under the regulations issued by the Internal Revenue Service, the election, once exercised, is irrevocable. (See IRS Regs. Sec. 1.167(1)-4(i)). In contrast, of course, under the third rule, changes can be made as found to be appropriate by the regulatory agency as to property not covered by the election or as to which the election was not exercised.

properly undertook to resolve that disagreement, and that its resolution, limiting the election to new expansion properties, in turn operated entirely to bar the regulatory agencies from permitting companies on flow-through to change to any other method of tax depreciation. See FPC Pet. 43-45.

However, once it is recognized that the Senate accepted the third general rule and intended the election to be an addition to, not a substitute for, the third rule, then it becomes clear that there was no disagreement between the Senate and House versions on this score within the authority of the Conference Committee to resolve. (See Section 136 of the Legislative Reorganization Act of 1946, 2 U.S.C. 190(c)).[16] In addition, since the third general rule, as proposed by the House and accepted by the Senate, is separate and distinct from the Senate's proposed election, the action of the Conference Committee in limiting the election to new expansion properties did not operate to impose any limitation upon the operation of that rule.

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[16] Section 136 provides in pertinent part:

"(a) In any case in which a disagreement to an amendment in the nature of a substitute has been referred to conferees, it shall be in order for the conferees to report a substitute on the same subject matter; but they may not include in the report matter not committed to them by either House. They may, however, include in their report in any such case matter which is a germane modification of subjects in disagreement.

"(b) In any case in which the conferees violate subsection (a), the conference report shall be subject to a point of order."

See also: Constitution, Jefferson's Manual and Rules and Practice of the United States, 92nd Congress, Lewis Deschler, Parliamentarian, U. S. Govt. Pr., 1971, p. 270.

2. The Conference Committee Report Does Not in Fact Support the Court of Appeals' Conclusion

Contrary to the Court below, the Conference Committee did not, in fact, undertake to eliminate or modify, in any way, the third general rule as proposed by the House and accepted by the Senate. The Court purports to have found evidence of such an undertaking in the following statement in that Committee's Report (See FPC Pet. 33-34):

> "1. *Depreciation allowed regulated industries (sec. 167 of the code)*
>
> "The House bill provides that in the case of certain regulated industries (the furnishing or sale of . . . gas through a local distribution system, . . . and transportation of gas by pipeline) a taxpayer is *not permitted* to use accelerated depreciation *unless it normalizes* the current income tax reduction resulting from the use of such accelerated depreciation. . . .
>
> "*This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account.* Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.
>
> "The Senate amendments make the following changes in the House bill: . . . (d) *an election is permitted to be made within 180 days after the date of enactment by a company at present on flow-through to come under the rules of the bill;* . . .
>
> "*The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) follows the Senate amendment except that the special provision referred to in (e) above is stricken and the 180-day election (item (d), above) is modified to*

apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flow through method is to be available only to the extent the new property increases the productive or operational capacity of the company." (Emphasis by Court below).

According to the Court below, the effect of the italicized language in the second paragraph of the above quotation is, to quote that court (FPC Pet. 34), that "since Texas Gas has been employing liberalized depreciation with flow-through, it is specifically prohibited, under the final version of the bill, from abandoning such depreciation* * *".

But a careful reading of this excerpt belies the imposition of any such prohibition. The first two paragraphs plainly are intended only to summarize the three general rules provided in the House bill, with the first paragraph summarizing the House's proposed second rule, i.e., that a company on liberalized depreciation with normalization was not to continue liberalized depreciation unless it also continued to normalize. Accordingly, the reference implicit in "This rule", which constitutes the first two words of the second paragraph clearly is to the second rule and is intended to indicate that that rule did not apply to companies on flow-through. That is so, because, the text of the first sentence of the second paragraph is a clear reference to the third general rule, i.e., companies on flow-through are to remain on flow-through unless permitted by the regulatory agency to change to normalization or straight-line. In other words, the first sentence of the second paragraph is intended, *albeit* somewhat inartistically, as a statement of the third

general rule with the second sentence in that paragraph completing the summary of the three general rules, i.e., that companies on straight-line may not shift at all to any form of liberalized depreciation.

That the italicized language in the second paragraph does not contain the prohibition purportedly found therein by the Court below is further indicated by the facts (1) that only with the third paragraph of the excerpt did the Conference Committee reach the changes in the bill proposed by the Senate; and (2) that only in the fourth paragraph of the excerpt did the Conference Committee deal with its proposed resolution of the differences between the two bills. Significantly, while the third paragraph refers to the election added by the Senate bill and the fourth paragraph explains the limitation upon that election added by the Conference Committee, there is nothing in either of those paragraphs indicating that the election as proposed by the Senate, or as revised by the Conference Committee, was intended as a limitation upon, or a replacement of, the three general rules as proposed by the House.

Indeed, the absence of any such discussion is perhaps the strongest evidence possible—shy of an explicit affirmative statement—that there was no intention to limit or eliminate the third general rule. We show in greater detail, *infra*, pp. 42-48, that one of the principal areas, if not *the* principal area, of concern to the members of the House Committee in considering this problem was the increasing trend among regulatory agencies to require the utilities subject to their jurisdiction to use liberalized depreciation and to flow-through the benefits of that method of tax depreciation. The latter aspect of this trend caused particular concern since it was resulting in substantial tax revenue

losses which had not been anticipated originally. Consequently, in proposing the three general rules, the House Committee was seeking both to forestall an increase in the tax revenue losses which would result from a continuation of these trends and to reverse that trend by leaving the way open for changes to slower methods of tax depreciation.

In these circumstances, it is difficult to believe that the House conferees would have agreed to legislation under which, except for an election relating only to limited properties and available for only a limited time, companies on flow-through would remain on flow-through indefinitely, so that there would be an indefinite perpetuation of the related revenue losses. It is even more difficult to believe that assuming that the House conferees had, in fact, agreed to such a result, they had nevertheless failed to point out this departure from their previous position either in the text of the Conference Committee report itself or during the House debates on that report. Yet, the fact is that there is nothing either in that Committee report or the subsequent debates which, in any way, even intimates the existence of any such change in attitude or approach by the House conferees.

The absence of any indication of any such change is strong evidence that no such change was intended and that, to the contrary, the House Committee's aversion to flow-through continued to pervade the proposed legislation. Indeed, in line therewith, it is noteworthy that the Conference Committee report stated that the Committee had struck a special provision added by the Senate permitting "a company under specified circumstances to avoid the rules of the bill by changing from normalization to flow-through" (H. Rep. No. 91-782, *supra*, at p. 313, App. C, *infra*, p. 91).

3. The General Explanation of the Tax Reform Act Prepared by the Staff of the Joint Committee Further Indicates that the Bill as Agreed to in Conference Did Not Revise or Eliminate the Third General Rule

Subsequent to the enactment of the 1969 Tax Reform Act, the Staff of the Joint Committee on Internal Revenue Taxation issued a document dated December 3, 1970 entitled "General Explanation of the Tax Reform Act of 1969, H. R. 13270, 91st Congress, Public Law 91-172."[17] Examination of the General Explanation makes clear the Joint Staff's understanding that Section 441 as finally enacted included the third general rule and that it was separate and apart from the right of election as limited by the Conference Committee. The Joint Staff states, with respect to existing property, (General Explanation, p. 151):

* * * *

"(3) If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so (except for a special election procedure discussed below), unless the appropriate regulatory agency permits a change as to that property.* * *

"In the case of new property, the Act provides that if the taxpayer as of August 1, 1969, flowed through to its customers the benefits of accelerated depreciation then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change (or unless the election below applies)."

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[17] In its letter of transmittal accompanying this General Explanation, the Joint Staff notes that, unlike reports of the respective committees which explain the legislation as proposed by the Committees, there usually had not been any report to explain the final legislation as passed by the Congress and that, since there have been many changes between the Tax Reform Act as passed by the House or Senate and as finally enacted, it had prepared the Explanation to fill the gap and thereby to provide explanations of the Act as finally enacted (Joint Explanation, p. iii.)

and then on the following page 152, the General Explanation goes on:

> "As indicated above, for a limited period of time and to a limited extent utilities on flow-through could elect straight line depreciation or accelerated depreciation with flow-through.* * *"

By thus setting forth the third general rule separately from the right of election as well as separately for existing and for new properties (remember: the election as finally enacted extended only to new expansion properties), the Joint Staff plainly manifests its understanding that that third rule was intended as part of the final bill, separate and apart from the election.

In its opinion on rehearing, the Court below goes to great lengths in an effort to disparage the first of the above statements in the Joint Staff's General Explanation (See FPC Pet. 47-52). In this regard, the Court urges that the language used in that statement "was lifted, with only minor modifications, from the House and Senate reports, both of which were commenting on the instant House version of Section 441 (a)." (FPC Pet. 48-49). But, as shown, *supra*, at pp. 17-22, the language as lifted from both the House and Senate version, was addressed, as far as the Senate version was concerned, to *both* "the House bill *and* to the [Senate Committee] amendment." In short, the Senate version provided for the same third general rule as provided in "the House bill". Consequently, the fact that the General Explanation lifted its language in this regard from the House and Senate versions serves to emphasize the identity of the provisions of both versions with regard to the third general rule.

Further, the Court below claims (FPC Pet. 49) that "At best this language is confusing and uncertain; it

cannot carry the meaning ascribed to it by the Commission and Texas Gas, particularly in view of the following page 152, discussed *infra*." But again, the Court is in error—the language is confusing and uncertain only when read, as done by the Court below, to indicate that the election proposed by the Senate was intended to replace the third general rule. As explained earlier, the language is clear and there is no confusion or uncertainty when it is recognized that the Senate Committee intended the election as an addition to, not a replacement for, the third general rule. So read, there is no confusion that the right of election, described at p. 152 of the General Explanation, to which the Court below later referred (FPC Pet. 49-50), is separate and apart from the third general rule.

Again, the Court below asserts (FPC Pet. 49) that:

> "* * * [T]here never was at any time in any version of the House, Senate, or conferees, a power in the agency to compel or permit a company to change from any method of depreciation accounting to flow-through. To have included such a provision would have been directly contrary to the overall objective of this portion of the Act—'in general to "freeze" the current situation regarding methods of depreciation.'"

In so urging, the court below apparently had in mind the sentence in the excerpt on page 151 of the General Explanation (omitted from the quotation set out, *supra*, above) to the effect:

> "That is, the Act does not require the taxpayer to flow through, but it also does not affect any power the regulatory agency might have to require the taxpayer to flow through."

We agree that the sentence appears to be garbled and, as urged by the Court below, it would be inconsistent with the Act's purposes thereafter to permit companies to change *to* flow-through either *sua sponte* or pursuant to an order of its regulatory agency. See, *infra*, pp. 39-41. Indeed, as shown, *supra*, p. 31, the Conference Committee eliminated from the Senate version a proposal to permit changes to flow-through in certain limited instances.

However, the fact that Congress was opposed to changes *to* flow through does not help the construction of the Court below that, under Section 441, companies on flow-through were prohibited entirely from changing *from* flow-through with respect to existing properties and permitted to change *from* flow-through for new properties only for a limited period of time and with respect only to limited types of property. Likewise, that fact does not detract from our reading that Congress intended to include the House's third general rule in the bill as finally enacted so that companies on flow-through could change *from* flow-through to other methods of tax depreciation if permitted by the regulatory agency.

Finally, the Court below contends (FPC Pet. 51) that to:

> "take Texas Gas' and the Commission's evaluation of the words on page 151—and ignore page 152 completely—then the exception is for all property and swallows up the whole, thus vitiating any congressional intent 'to freeze' generally depreciation accounting practices for utilities."

But our reading of page 151 does not require an ignoring of page 152; it just involves a recognition that the third general rule, described on page 151, is separate and distinct from the right of election described on

page 152. For this reason, also, such recognition does not involve the exception swallowing up the whole or vice versa, for, as shown *supra*, pp. 24-25, the general rule and the election have different operational effects, and hence, there is no conceptual or factual obstacle to two existing side by side independently of the other. Nor does our reading vitiate the "freeze" intended by Congress; to the contrary, as shown, *infra*, pp. 37-53, our reading is entirely consistent with that "freeze."

II.

THE COURT'S CONCLUSION THAT SECTION 441 WITHDREW AGENCY AUTHORITY TO PERMIT COMPANIES ON FLOW-THROUGH TO CHANGE TO OTHER METHODS OF TAX DEPRECIATION IS INCONSISTENT WITH THE CONGRESSIONAL PURPOSES IN ENACTING THAT SECTION

The Court below sought further to buttress its conclusion that Section 441, as finally enacted, operated to withdraw agency authority to permit companies on flow-through to change to other methods of tax depreciation by referring to the Congressional purposes in enacting that provision. Thus, in its main opinion, the Court claimed that the Commission's holding permitting Texas Gas to change from flow-through to normalization with respect to its existing properties "produce[s] an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969" (FPC Pet. 34).

We will show that it is the conclusion of the Court below which is at odds with the Congressional purposes. Properly understood and evaluated, these Congressional purposes require the continued survival of authority in the regulatory agencies to determine whether, in the circumstances presented, it is appropriate to permit the company involved to change from flow-through to another method of tax depreciation.

A. The "Freeze" Was Intended Only To Bar Changes To Faster Methods of Tax Depreciation

In support of its result, the Court below claimed that its holding was in accord with the Congressional purpose to "freeze" the current situation regarding the methods of depreciation. Thus, in its main opinion, the Court asserted (FPC Pet. 34-35):

> "* * * The Report of the House Committee on Ways and Means states:
>
> 'Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.
>
> *'Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries.* (footnote omitted).
>
> "The Senate Report agreed with this perspective, stating in relevant part:
>
> 'Accordingly, the committee agrees with the House that is *appropriate to in general* [*sic*] *"freeze" the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more flourishing utility industries.'" (emphasis in original).

And in its opinion on rehearing, the Court further elaborated (FPC Pet. 46):

> "In permitting a taxpayer such as Texas Gas to shift from accelerated depreciation with flow-

through to straight-line depreciation with or without the appropriate agency's approval, the Senate was no doubt interested in increasing governmental revenues (since under flow-through the tax reduction is passed on to the utility's customers). The House, however, by limiting changes from flow-through either to straight-line or normalization *only with* agency approval, was reflecting the concern that emphasis on a shift to straight-line depreciation, as expressed by the Senate version, would place taxpayers such as Texas Gas at a competitive disavantage, both as to the sale of their products or services and as to their attractiveness to equity investors. (footnote omitted).

"Thus, the conferees' resolution of this disagreement in favor of the latter concern by limiting the extent to which regulated utilities may abandon flow-through reflects Congress' overall intent in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries."

But in concluding that the "freeze" thus intended by Congress supports its holding that Section 441 barred regulatory agencies from permitting companies on flow-through to change to other methods of tax depreciation, the Court below overlooked a number of significant factors and considerations. As a result, it is the Court's position—not that of Texas Gas and the Commission—which fails to give appropriate consideration to the overall Congressional objective to forestall prospective revenue losses, without handicapping the utility industry.[18]

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[18] As noted, *infra*, p. 49, the FPC recommended the elimination entirely of liberalized depreciation for the natural gas pipeline industry on the ground that that industry did not need the incentives thereby intended to be provided, and hence that the elimination thereof would not handicap it.

1. The House Report Provided Simultaneously for the Three General Rules and the "Freeze"

At the outset, it should be noted (1) that the House Committee report, on which the Court below places such heavy emphasis in support of its result, includes the three general rules dealing with the methods of tax depreciation to be available to regulated companies, and (2) that the third general rule thus included expressly provided that companies on flow-through could change to other methods of tax depreciation if permitted by their regulatory agency.

Indeed, as pointed out *supra* at p. 15, the Court itself expressly recognized that the Commission action herein would have been *fully justified* under the bill as recommended by the House Committee and adopted by the House. In other words, as far as the House bill was concerned, the existence of authority in the regulatory agencies to permit companies on flow-through to change to other methods of tax depreciation is wholly consistent with the "freeze" as envisioned under that bill.[18a]

2. The "Freeze" Is Built Into the Three General Rules

This brings us to the nature of the "freeze" itself and in this respect, the Court's view as to the freeze again does not accord with the Congressional intent. To be sure, as stated by the Court (FPC Pet. 46), "Congress intended to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy industries". But the "freeze" was not absolute; both

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[18a] Similarly, the Senate Committee provided for a freeze "in general" in substantially the same language as the House. However, as the Court below agrees, utilities could, under the 180-day election, shift from flow-through with respect to all their property, old as well as new. Therefore, it is perfectly apparent that the freeze language could not be interpreted as an absolute bar to shifts from flow-through.

the House Report (at p. 133, App. A, p. 79) and the Senate Report (at p. 172, App. B, p. 82) provide only for a freeze "in general". Moreover, Congress did not intend the freeze to be tied directly into the competitive status of particular utilities or industries. Rather the "freeze" is designed to be tied into the method of tax depreciation being used by the affected companies on the critical date and is built into the three general rules provided in the House bill.

Thus, as already noted earlier herein, the first rule expressly provides that companies on straight line depreciation are to continue to use that method of tax depreciation. The second rule provides that companies on liberalized depreciation with normalization may continue to use liberalized depreciation only if they continue also to use normalization; otherwise, they have to change to straight line depreciation. Finally, the third general rule requires companies on flow-through to continue to use that method *unless permitted to change to another method of tax depreciation by their regulatory agency.*

It is to be observed that each of these rules operates so as to bar any company from changing to a *faster* method of tax depreciation than that currently being used by that company. In other words, since tax revenue losses occur when a company changes to a faster method of tax depreciation, the effect of these restrictions built into the three rules against changing to faster methods of tax depreciation is to put a halt to any further increases in tax revenues losses which otherwise might have resulted.

Also, it is to be observed that the "freeze" was solely one-way in that, at the same time that it precludes changes to *faster* methods of tax depreciation, it does *not* preclude changes to *slower* methods. Thus, a company on liberalized depreciation with normalization

could shift to the slower straight line depreciation—but not to the faster flow-through. Likewise, companies on flow-through could, with agency permission, shift to the slower straight-line or normalization, whereas companies on straight-line—already on the slowest method of tax depreciation—are not permitted to change their method of tax depreciation, even with agency permission.[19]

3. The "Freeze" Built Into the Three General Rules Is the Congressional Solution to a Dilemma

This "freeze" *prohibiting changes to faster* methods of tax depreciation, *but not to slower* methods of tax depreciation constitutes the solution adopted by the House and Senate Committees to resolve the dilemma with which they regarded themselves as being confronted in this area.

On the one hand, both the House and Senate Committees involved were gravely concerned over the loss of tax revenues being suffered by the Federal Treasury as a result of the trend among the various Federal and State regulatory agencies to require the use of faster methods of tax depreciation. On the other hand, they were acutely aware that prohibiting regulated companies from using these faster methods of tax depreciation would in many instances adversely affect the competitive position of some of these companies. The three general rules constitute the answer adopted by the Committees to accommodate these conflicting considerations.

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[19] The American Public Gas Association opposed adoption of the three general rules, particularly the third rule expressly on the ground that they would operate to "inhibit the expanded use of accelerated depreciation and flow-through of the savings resulting therefrom for rate making purposes, * * *". See Hearings before the Senate Committee on Finance on H.R. 13270, 91st Cong., 1st Sess., Part 2, pp. 1387-1388; Part 6, pp. 6584-6585.

(a) *Congress Was Gravely Concerned Over the Substantial Tax Revenues Being Lost as a Result of the Use by Regulated Companies of Liberalized Depreciation and Flow-Through*

The reports of both the House and Senate Committees indicate that both Committees were gravely concerned over the trend among the regulatory agencies to require companies on straight-line to change to normalization and companies on normalization to change to flow-through (H. Rep. No. 91-413, *supra* at p. 132, App. A *infra* p. 78, S. Rep. No. 91-552, *supra* at 72 *infra* p. 81). Statistics submitted in the Hearings before the House Committee [20] indicated that the situation had reached the point that:

> "* * * utilities in 20 states must normalize; 17 must flow-through, and 13 state commissions have taken no action whatsoever. Meanwhile, the Federal Power Commission has ordered flow-through for both rate and accounting treatment. On the other hand, the Securities & Exchange Commission has taken no action on the rate treatment, but it will allow either normalization or flow-through in accounting. The Federal Communications Commission has also taken no action on rate treatment, except to say that the failure to use accelerated depreciation for taxes is considered in fixing the rate of return. On accounting treatment, the FCC has taken no action. The Civil Aeronautics Board has ordered normalization for rates [reserve de-

[20] Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess. on the subject of Tax Reform (hereinafter called "House Hearings"). It is interesting to note that the House Committees both heard extensive oral testimony and received written transmittals (see House Hearings, Part 10, pp. 3535, 3806, Part 11, pp. 3819-3969) whereas the Senate Committee heard no oral testimony and confined itself to limited written transmittals, the bulk of which is reproduced in the Hearings of the Senate Committee on Finance on H. R. 13290, 91st Cong., 1st Sess. Part 5, pp. 4963-4982.

ducted from rate base] and it has taken no action on the accounting treatment. The Interstate Commerce Commission has ordered flow-through for both rate and accounting treatment. Canada has ordered normalization for both." (See House Hearing at p. 3967-3968; see also pp. 3592, 3594, 3673).

The House and Senate Committees were concerned about the losses of tax revenues resulting from these trends toward the use of faster methods of tax depreciation since losses were already substantial (estimated to have reached $1.5 billion annually) and were threatening to become even greater if the trend were permitted to continue (House Hearings, *supra*, at p. 3884).[21] They were also concerned because one of their major responsibility was the recommendation of legislation to provide adequate revenues with which to operate the Federal Government and they felt very keenly that the greater the tax revenue losses in this area, the greater was the burden upon them to increase the tax revenues from other sources (*e.g.*, House Hearings, *supra*, at pp. 3567, 3753, 3884-5, 3871).

They were particularly upset about the tax revenue losses resulting from the increasing use of flow-through; in their view, not only were such revenue losses disproportionately great but they were unanticipated and inconsistent with the Congressional purpose in enacting the original legislation. The magnitude of the revenue losses resulting from the use of flow-

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[21] As stated in the House Committee Report (H. Rep. No. 91-413, *supra*, at p. 132):

"Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion: some estimates indicate that the loss might be considerably closer to $2 billion per year * * *". See also S. Rep. No. 91-552, *supra*, at p. 172.

through stemmed from the fact, summarized in the Senate Committee Report (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra* p. 81) that: "In general, flow-through to customers doubles the tax revenue loss involved in shifting from straight-line to accelerated depreciation." (See also, e.g., House hearings, *supra*, at pp. 3633, 3635, 3695-6). This doubling of the tax revenue losses came about by virtue of what is commonly called the "tax on tax" effect. In other words, this is so:

> "* * * because the current tax reduction reduces the rates charged to customers, which in turn reduces the utility's taxable income and therefore reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect. Assuming no other factors become involved, the total loss of taxes may be computed as the initial loss divided by the excess of 100 over the utility's marginal tax rate. At the present surcharge rates, the total tax loss is 212 percent of the initial loss; without the surcharge, the total loss is 192 percent of the initial loss." (H. Rep. No. 91-413, *supra*, at p. 132, App. A, *infra*., p. 78).

While this concern was shared by many of the members of the House Ways and Means Committee, perhaps the most vocal was Committee Chairman Mills.[22] For example, during the questioning of Mr. Van Scoyoc, a witness appearing on behalf of a number of consumer groups in opposition to any change in the *status quo*, (House Hearings, *supra*, at p. 3739-40), Chairman Mills commented, *inter alia* (House Hearings, *supra*, at pp. 3753-54):

> "The CHAIRMAN. What I am getting at is this: What would be wrong with a provision which says

[22] Chairman Mills, of course, was also a member of the Conference Committee. See H. Rep. No. 91-782, *supra*, at pp. 1, 346.

that if a commission, regulatory agency, State or Federal, is going to require a taxpayer, through ratemaking purposes, to go on a more rapid method of depreciation, that the Secretary of the Treasury has the authority to withdraw the privilege for tax purposes from the taxpayer and put him on straight line?

Maybe it is because of where I sit, but I do not like to have these agencies of Government establish a fiscal policy by doing away with provisions of tax law. Then to have us wake up one of these days to the fact that we are getting $1,500 million less revenue because of a decision with respect to the use of depreciation, made by some regulatory commission downtown or out in some State capital."

Why can't we arrange to give the Secretary of the Treasury, the caretaker of the Federal revenues under laws enacted by the Congress the authority to protect the Federal revenues?

* * * *

The CHAIRMAN. He is not going to regulate rates. He is not going to tell you what to do. He is just going to say, "I will not let you strip me bare of my revenues and use them for the purpose of subsidizing rates."

Subsequently, in discussing with Commissioner Morrissey of the California Public Utilities Commission, the action of that Commission in trying to force Pacific Telephone and Telegraph Company to change from straight line depreciation to liberalized depreciation with flow-through by fixing the tax allowed in its rate as if it had used flow-through, Chairman Mills further commented (House Hearings, *supra,* at pp. 3882-3884):

* * * *

"Certainly, you have thwarted the Federal policy, the will of the Congress, if you pass it through in

total to the consumers of the service of the utility. You are doing just as much of a wrong as we may have done in the beginning in establishing this policy.

* * * *

"How can we get out of this conflict of State and Federal goals? You want your rates to be as low as possible, and I want to have them, for the benefit of your consumers in California, as low as they should be. I don't want you, through this device, however, to take money from the Federal Treasury and to subsidize rates when we intended it as a subsidy of the business to create employment.

* * * *

"The CHAIRMAN. But you see the whole purpose of this hearing is to determine whether we want these so-called preferences, or as Mr. Madden called them this morning 'loopholes' or as somebody else said 'subsidies,' to continue.

The question here is whether we want the tax laws of the United States to divert from $125 to $150 million of what would otherwise be Federal revenue for the benefit of the consumers of utility services in California. * * *

At any rate, * * * * * * the question is whether we want our tax laws to be used to subsidize somebody.

Mr. MORRISSEY. I do not agree with the word subsidy in that respect.

The CHAIRMAN. What is it called when it goes to consumers as opposed to the oil company, the realtor or somebody else?

Mr. MORRISSEY. It is a reduction in taxes, sir, because the ratepayers and utilities are also the taxpayers.

The CHAIRMAN. We are not reducing the utility rates of people in California in this manner and we are not doing it in Arkansas, not as long as I

am chairman of the committee, my friend. I don't want it standing in the record that we voted in Congress to reduce the tax burdens of the people in California and in no other State in this manner.

I can assure you about that.

* * * *

"Mr. MORRISSEY. Sir, I would help you get out of this dilemma sir, by having the Arkansas Commission, I guess, go to flow through if the growth prospects for the utilities in Arkansas—

THE CHAIRMAN. They are great.

Mr. MORRISSEY. If that is so, then you should get your commissioners on the telephone.

The CHAIRMAN. That is not the kind of tax reduction my people are talking about. They never mentioned doing it this way. First of all they don't want the 10-percent surcharge extended. They would like to have that replaced by doubling the personal exemption, and a few other things, but they never write me about reducing their taxes by reducing their utility costs. Maybe that is an idea that just hasn't occurred to them.

Mr. MORRISSEY. I suggest to you to talk to them about it.

The CHAIRMAN. Do you mean to just leave this like it is?

Mr. MORRISSEY. Yes sir.

The CHAIRMAN. Do you know how much Federal revenue is that would be involved if we leave it like it is, if you and all these commissions force these people to flow through and everybody uses accelerated depreciation, but nobody gets the benefit except the consumer service? Do you know how much it amounts to?

Mr. MORRISSEY. I would suspect something like three-quarters of a billion dollars.

The CHAIRMAN. You are about half of the way there. It is $1.5 billion when extended across the board.

What you do, in your zeal to get a rate as low as you can get it, and I am not fussing about it because that is your responsibility, when you make a corporation elect to do something that it would not otherwise do because it reduces its tax payment that you can then use as a basis for lower cost of the service, you are requiring that company to pay less Federal tax at a time when we need so much more.

This comes when your Governor and other Governors are asking us to share revenues with them. I have offered to do it if they will let us share the Federal deficit with them. But you see, we are working at cross-purposes, I think."[22]

In light of these reactions by the members of the House Committee, it is easy to understand the comment in that Committee's report (H. Rep. No. 91-413, *supra*, at 132, App. A, *infra*, p. 78):

> "Your Committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow through is unacceptable at this time."

And the Senate Committee Report is to the same effect (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra*, p. 81):

> "In general, flow-through to customers doubles the tax revenue loss in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this item is unacceptable at this time."

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[22] For the reaction of other House Committee members on these problems, see House Hearings, *supra*, at pp. 3870-3899.

(b) *Congress Was Concerned that Withdrawal of Liberalized Depreciation Would Place Regulated Companies at Competitive Disadvantage*

Although, as just indicated, both the House and Senate Committees were strongly opposed to the continuation of the rate reductions or "subsidies" resulting from the flow through requirements of many of the regulatory agencies, they were also aware that it was impractical to do away entirely with the "subsidy". In this regard, it is noteworthy that the Federal Power Commission, which has long been the leader in requiring flow-through, advised the House Committee, through its Chairman, that in its view, the electric and natural gas utilities subject to its jurisdiction did not need the incentives intended to be provided by liberalized depreciation, and hence it recommended that liberalized depreciation be withdrawn from regulated companies so as "not to give them that subsidy, so to speak". (See House Hearings, *supra*, at p. 3567; see also pp. 3542, 3548, 3555).

However, the ICC, FCC, CAB, along with representatives of the electric utility industry, among others, opposed the withdrawal of liberalized depreciation as suggested by the Power Commission on the ground, *inter alia*, that it would place companies subject to regulation at competitive disadvantage with their non-regulated competitors. See House Hearings, *supra*, at pp. 3584, 3585, 3600, 3603, 3604, 3760. For example, the FCC urged (House Hearings, *supra*, at p. 3600):

> "We see no reason why the utility, simply because it is ordinarily not subject to competition, should not have the same opportunity, subject to proper

regulatory review, to employ rapid depreciation with the same options as Section 167 extends to unregulated business. In other words, under appropriate circumstance it may well be in the best interest of the utility and its customers for the benefits of accelerated depreciation to be applied for purposes other than the expansion of its plant capacity.

Moreover, there are many areas in which the regulated utility finds itself in a form of competition with the nonregulated sector. For example, in the field of communications, a nonregulated business can choose to construct and operate its own private microwave communications system, rather than meeting its communications requirements by lease from the regulated common carriers. Whether or not it will do so can turn largely on the economics of the choice. In this context, a decisive difference in cost could result if tax savings from rapid depreciation of the privately-owned microwave facilities were available to the unregulated business, but would be denied to the common carriers if the FPC proposal were to be adopted. Under such circumstances the common carrier would be at a disadvantage in competing for the communications business of the unregulated sector solely because of the change in tax policy."

That both Committees were concerned with the dilemma created by these conflicting objectives is apparent from their respective reports. Thus the House Committee, after noting that the substantial revenue losses resulting from the use by the regulated industries of liberalized depreciation and flow-through was "unacceptable", goes on to comment (H. Rep. No. 91-413, *supra*, at 132, App. A, *infra*, pp. 78-79):

"Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too

many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors.* * * "

Similarly, the Senate Committee, after likewise noting that such revenue losses were "unacceptable", went on to point out (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra*, p. 82):

> "On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation."

(c) ***The "Freeze" Built Into the Three General Rules Not Only Forestalls Additional Revenue Losses and Prevents Impairment of the Competitive Position of Regulated Companies, But Leaves the Way Open for Reduction of the Revenue Losses.***

The Committee apparently found an acceptable resolution of the dilemma created by the competing objectives in the three general rules. On the one hand, the "freeze" against changing to *faster* methods of tax depreciation built into these rules in effect serves to halt the trend in that direction and thereby to prevent any increases in the loss of tax revenues. On the other hand, by not disturbing a utility's present method of tax depreciation and leaving the way open for it to change to

a slower method, the three rules provide the leeway needed to protect the competitive position of the regulated companies needing such protection, while at the same time keeping the way open for reductions in the revenue losses through changes, where appropriate, to slower methods of tax depreciation. As noted *supra*, both the House and Senate estimated that the effect of the amendments would result in revenue increases of "60 million in 1970, $260 million in 1974 and $310 million in 1979." H. Rep. No. 91-413, *supra*, at 134, App. A., *infra*, p. 80; S. Rep. No. 91-552, *supra*, at 176, App. B., *infra*, p. 89.

In contrast, the Court's version of the Congressional resolution of this dilemma has a number of fatal infirmities. To be sure, under the Court's version, there would be a halt to any increase in the tax revenue losses and the competitive position of regulated companies would not be impaired. But, the Court's view that companies on flow-through are frozen to that method would be unfair to such companies since under the second general rule companies on liberalized depreciation with normalization would be permitted to change to the slower straight-line method of tax depreciation. More particularly it would be contrary to the fulfillment of any Congressional purpose, since flow-through is the fastest method of tax depreciation and represents the greatest tax revenue loss to the Treasury. In addition, a "freeze" on liberalized depreciation with flow-through would destroy the flexibility and ability to accommodate to changing conditions, for example, when the "crossover point"[24] is

[24] Under Section 167(e)(1) of the Internal Revenue Code, any taxpayer, using the double-declining balance method, may at any time elect to revert to a straight-line method over the remaining life of the property involved to recover the undepreciated portion

reached and the public interest is better served by changing from flow-through to other methods of tax depreciation.

And, finally, it would frustrate the Congressional purpose. Not only would it prevent the reduction in the tax revenue losses which would come about when such a company changes to a slower method of tax depreciation, but it would prepetuate the very type of tax revenue loss which the Act's legislative history so plainly discloses was obnoxious to many of the responsible members of Congress.

B. Congress Recognized That Rate Increases Would Be Necessary To Reflect Changes To Slower Methods of Tax Depreciation

In further support of its reading of Section 441, the Court below (FPC Pet. 35-36) quotes from a Summary of the Bill prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance to the effect:

> "The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws,

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thereof. This right was provided in order to enable the taxpayer to maximize his tax depreciation deduction and, consequently, to minimize his tax when the reversion to a straight-line method would provide greater tax deductions than would the continuation of the double-declining balance method. This point is definitely ascertainable and all would agree that it is in the public interest and prudent for the utility to revert to a straight-line method at this point of time which is commonly called the "crossover" point. Yet, as indicated above, the decision of the court below would preclude the utility taxpayer from shifting to a straight-line method thereby depriving the utility and its customers from the benefits of this reduction in taxes and consequent reduction in cost of service.

since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.[23]

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[23] "Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, at 73."

In relying on this excerpt, the Court below adopts, in effect, the claims advanced by respondent Memphis (Br. in Opp. pp. 3, 4, 6) that the practical effect of the Commission's interpretation "* * * is to necessitate present rate increases by practically all of the interstate natural gas pipelines as well as many other regulated utilities in the country", and that such a result is contrary to the express purposes of Congress, manifested, again according to Memphis, in the statements in the House and Senate Committee Reports relative to the "freeze", quoted *supra* at p. 37.

But, as is apparent from discussions relative to the "freeze", neither of the references thereto in the House and Senate Committe reports indicates an intent, on the part of these Committees, to avoid utility rate increases. To the contrary, the comments of Chairman Mills set out, *supra*, pp. 44-48 strongly indicate that while he was opposed to widespread rate increases because of their potential disruptive effect, the rate reductions which had in the past resulted from the use of the flow-through had themselves been unwarranted and contrary to the Congressional purposes. Consequently, in his view, the rate increases appropriate to reflect elimination of flow-through would in reality merely serve to eliminate an unwarranted subsidy and to restore rates to the level at which they should have been originally.

Memphis further argues (Br. in Opp., pp. 5, 7), that such rate increases would be at odds with (1) the House Committee's rejection of the FPC's suggestion to require all regulated utilities to change to straight-line depreciation because it "would result in prompt, substantial and widespread utility rate increases" (H. Rep. 91-413, *supra*, at p. 132, App. A, *infra*, p. 79) and (2) the above statement from the Summary by the Joint Committee Staff, which Memphis quotes as support for the argument that:

> "When the bill was molded into its final form, the Congress was still of the firm impression that it had avoided any widespread substantial utility rate increases." (Memphis Br. in Opp., p. 7).

However, these additional references likewise do not support the conclusion urged by Memphis and adopted by the Court below. To begin with, it should be noted that the House bill contained the three general rules and the Court below expressly recognized that "the Commission's and Texas Gas' position here [was] clearly justified" had the House bill been enacted. See *supra*, p. 15. But that's really beside the point since, in addition, the statement in the House Committee report was directed to an entirely different situation from that provided in the bill as enacted. Even if the Commission action taken here were to result in rate increases for wholesale gas and electric companies generally, the increases involved would be substantially less than those indicated under the Power Commission's suggestion since that suggestion would have imposed an *obligation* to change to straight-line depreciation whereas the Commission action here merely *permits* a change and then only to liberalized depreciation with normalization. And since, as suggested by both Committees (H. Rep. No. 91-413, *supra* at 133, App. A, *infra* p. 80;

S. Rep. No. 91-552, *supra*, at p. 173, App. B, *infra*, p. 83), the Commission excludes from rate base, upon which a return is computed, the special reserve reflecting the difference between taxes due and taxes allowed (Ref. R. 111) the rates under normalization patently are lower than under straight-line depreciation.

In addition, such increases would be substantially more limited in extent than indicated by the House Committee's comment, since the increases would involve primarily the wholesale gas and electric industries whereas adoption of the FPC proposal would have involved rate increases in all of the several additional regulated industries covered by Section 441.[25] As pointed out earlier, however, the testimony at the House Hearings indicated that many of the companies in the other industries covered by Section 441 would not be in a position to change to a slower method of tax depreciation and so they would not need compensatory rate increases.

In any case, it should be noted that while the Committees did not expect the widespread rate increases which would have resulted had the FPC suggestion been adopted, they did expect that adoption of the three rules would result in increases of tax revenues (which in turn would result from rate increases). See *infra* p. 58; see also H. Rep. No. 91-451, *supra* at p. 134; App. A, *infra* p. 80; S. Rep. No. 91-552, *supra*, at p. 176; App. B, *infra*, p. 89. Rate increases such as

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[25] Section 441 in terms applies to all properties used predominantly in the trade or business of the furnishing or sale of

(a) electrical energy, water or sewage disposal services;

(b) steam or gas through local distribution systems;

(c) telephone services and other communication services if furnished or sold by Comsat; and

(d) transportation of gas or steam by pipeline.

those claimed by Memphis with respect to the wholesale gas and electric industries are well within the range of increases contemplated at the House Committee hearings.

Thus, during these hearings, Congressman Byrnes first asked Chairman White of the Federal Power Commission as to the rate effect of a general repeal of liberalized depreciation and received the following answer (House Hearings, *supra*, at p. 3568):

> "Mr. BYRNES. If we repealed the accelerated depreciation provisions as they relate to utilities, it would require a new round of rate changes, wouldn't it?
>
> Mr. WHITE. In all likelihood.
>
> Mr. BYRNES. They would have to come to you to get permission to raise their rates. I assume they can reduce their rates without coming to you, can't they?
>
> Mr. WHITE. No, that too comes to us although it gets filed with us and hardly anybody ever excepts to it.
>
> Mr. BYRNES. It isn't seriously contested.
>
> Mr. WHITE. It isn't a serious problem to us, unlike some of my colleagues at the table here who do have that problem.
>
> Mr. BYRNES. But repeal of the accelerated depreciation provisions would entail quite a general round of rate negotiations or rate hearings and determinations?"
>
> Mr. WHITE. Yes, sir."[26]

At this point, Chairman Mills interjected by postulating a modified but less far-reaching revision than

[26] The answer by Mr. White apparently became the basis for the comment in the House Committee report relied on by Memphis.

that proposed by the Power Commission (House Hearings, *supra*, at pp. 3568-9):

> "The CHAIRMAN. Would it if we did it this way, Mr. Chairman?
>
> By our permitting a continuation of the accelerated method with respect to assets previously acquired, but with respect to assets acquired after a certain date require then the straight-line method of determining depreciation?
>
> Mr. WHITE. In that case the problem would be far simpler but there would still, I must state, be a very strong likelihood that the utilities which would then lose the benefit of those tax reductions, tax savings, would feel obliged to go to their regulatory agency and say, 'Now that this decision has been reached by the Congress and we no longer again can take advantage of liberalized depreciation we must therefore get enough money somewhere and we need a rate increase.'
>
> So there will be some.
>
> The CHAIRMAN. They would be slower in coming.
>
> Mr. WHITE. It would be much slower, that is correct."

Note for future reference that Mr. White's response pointed out that once the utilities lose the benefits of the tax reductions with respect to new properties, they very probably would need rate increases to offset the loss of these benefits.

And in response to further inquiry by Congressman Byrnes, Mr. White indicated that permitting each utility to make its choice would be even "less disruptive" (House Hearings, *supra*, at p. 3569):

> "Mr. BYRNES. I think we must ask whether we are going to move into a situation where action by

this committee forces a rash of additional rate adjustments. I wonder whether we could avoid that by using the alternative of simply saying that the utility can make its choice. A regulated utility that has been on accelerated depreciation but wants to move back could do so, knowing also that it will then become involved in a rate change.

This wouldn't involve all utilities. They would probably look to see whether the change is enough to suggest the need to come in for an increase in rates or enough to suggest that they shouldn't change back. At least those that are still on the straight line could stay on the straight line. Wouldn't that be less disruptive than to simply repeal the accelerated depreciation provision for utilities?

MR. WHITE. Yes, certainly it would be much less disruptive. But I think on the basis of the bill that is before the committee if the committee is to take that course of action, it must be I think very mindful of what it tells the regulatory agency to do with respect to those who do not go back to normalization or to straight line."

The bill as proposed by the House Committee would have left the choice in the first instance up to the regulated utility whether to change to a slower method of depreciation and hence would have been much "less disruptive" as far as rate increase filings are concerned. Thus, that bill permitted changes in the methods of tax depreciation only in accordance with the three general rules and, as pointed out earlier, these rules contemplated no change in tax depreciation for companies on straight-line and changes in tax depreciation by companies on normalization or flow-through to a slower method only on an individual basis and then only with the permission of the regulatory agency. By thus restricting the ability of a regulated company on

normalization or flow-through to change to a slower method of tax depreciation, the bill as proposed by the House would probably have resulted in relatively few rate increase filings. In other words, as stated in the Summary of the Staff of the Joint Committee, referred to by both the Court below and Memphis, had the bill as proposed by the House been enacted there would have been "(with very few exceptions) * * *no increase in utility rates."

This brings us to the error of both the Court below and Memphis in placing such heavy emphasis upon this Summary by the Staff of the Joint Committee. Contrary to the understanding of the Court below and the implicit representation by Memphis, this Summary reflects not the "bill [as] molded into its final form" (Memphis Br. in Opp., p. 7), but rather the bill "as passed by the House of Representatives". Not only does the latter appear in the inscription on the cover of that document, but the Summary itself bears the date of August 18, 1969 and is reproduced in the Part 1 of the Senate hearings on the bill which commenced on September 4, 1969—both well before the enactment of the final bill on December 30, 1969. See Hearings before Senate Committee on Finance on the Tax Reform Act of 1969, 91st Cong., 1st Session, p. 7, *et seq.*, including particularly, p. 85.

As is evident from the discussion earlier in this brief, the bill as passed by the House of Representatives was *not* the one passed by the Senate or the one enacted into law. Instead, the Senate bill granted to companies on flow-through a limited right of election in addition to the third rule with respect to existing and new properties and the bill, as it emerged from conference and finally enacted, contained that additional right of election limited, however, to only new expansion proper-

ties. The rate increase here involved, stems basically from Texas Gas' exercise of that right of election. As found by the Commission, the effect of Texas Gas' exercising that right of election with respect to its new expansion properties, was to do away with the tax savings needed to avoid the future repayment of taxes avoided earlier by utilizing liberalized depreciation; and, accordingly, the Commission concluded that it would be contrary to the public interest not to permit Texas Gas to change to normalization with respect to its existing and new non-expansion properties.[37] In other words, the rate increases which Memphis claims would result from the Commission's ruling herein would stem basically from the operation of the additional right of election, which were not part of the bill as passed by the House. In addition, these increases clearly come within the parameters of the answer given by Mr. White in his response to Chairman Mills' question on rate increases (*supra*, pp. 57-58)—since, as found by the Commission, the exercise of the right of election operates to wipe out the "benefits of tax reduction, tax savings" with respect to expansion properties, the companies would very probably need rate increases to offset the loss of these benefits.

Significantly, neither the Senate Committee report, the Conference Committee report, nor the later General Explanation of the Tax Reform Act prepared by the Staff of the Joint Committee on Internal Revenue Taxation (dated December 3, 1970) contains even a comment about widespread rate increases resulting from adoption of the FPC suggestion, much less any

[37] We show below in Part III that that Commission finding is supported by adequate evidence in the record and is in the public interest.

suggestion that the treatment of tax depreciation for regulated utilities proposed in the bill under discussion would not result in rate increase filings. To the contrary, the Senate Committee report (at p. 176) indicates that its revisions of the House bill in providing a special election would result in increases, in an unknown amount, in the tax revenues over and above the increases projected in the House and Senate Committee Reports related to the three general rules:

> "*Revenue effect.*—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election."

III. THE COMMISSION'S ACTION IN PERMITTING TEXAS GAS TO CHANGE TO NORMALIZATION FOR ITS EXISTING PROPERTIES WAS WELL WITHIN ITS DISCRETION

Once it is recognized that Congress did not intend Section 441 of the 1969 Tax Reform Act to withdraw authority from the Commission to permit companies subject to its jurisdiction to change from flow-through to other methods of tax depreciation with respect to their existing properties, the only possible remaining question might be: whether the Commission properly exercised its discretion in permitting Texas Gas to change from flow-through to normalization for its existing properties?[28] As we show below, the Commission's action was well within such discretion.

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[28] See fn. 8, p. 14, *supra*.

A. The Choice of Method of Tax Depreciation Is Generally a Matter for Commission Discretion

The past cases dealing with Commission rulings with respect to the appropriate tax depreciation method to be used for rate-making, as well as accounting, purposes have uniformly affirmed such rulings as matters committed to the Commission's expertise and discretion.

Such, for example, was the holding of the Fourth Circuit in *City of Lexington* v. *F.P.C.*, 295 F.2d 109, 114 (1961) in affirming the approach originally adopted by the Commission that companies subject to its jurisdiction should be permitted to normalize, for rate purposes, the Federal income taxes allowed in their cost of service. At that time, the Commission had taken the view that the use of liberalized depreciation resulted in a tax deferral and, accordingly, in order to prevent the present rate payers from benefitting at the expense of the future rate payees and *vice versa*, the Commission directed that the difference between the income tax allowed and the actual taxes paid under that method of tax depreciation should be kept in a special restricted reserve account to be available, as needed, to pay the higher taxes of later years. See, e.g., *Amere-Gas Utilities Co.*, 15 F.P.C. 760, 781 (1956). In affirming that Commission ruling, the Fourth Circuit noted the variety of views on this subject among the courts and among the Federal and State Commissions (295 F.2d at 114) and concluded (*Id.* at 124):

> "It is obvious that we are confronted in this case with a problem in a special field which requires the exercise of expert skill that has been generally entrusted to administrative tribunals whose deci-

sions in the absence of abuse of discretion should be followed by the courts."[29]

Subsequently, when the Commission, in a reversal of its earlier position, found that the use of liberalized depreciation generally resulted in a permanent tax savings and directed that these "savings" be flowed-through to the customers in the form of reduced rates, the Fifth Circuit's affirmance similarly stressed the Commission's expertise and absence of abuse of discretion. See *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F.2d 318 (5th Cir. 1966) *cert. denied*, 385 U.S. 847 (1966). Pointing to the Commission's reasoning that the natural gas industry was a growing, or at least a stable, industry and hence, according to the Commission, the use of normalization resulted in a tax savings rather than a tax deferral, the Court concluded (359 F.2d at 339):

> "In final analysis, putting to one side the issue of Congressional intent, the petitioners' challenge to the FPC order addresses itself to the competency of the Commission to choose between competing accounting theories and competing economic guesses. We see nothing irrational in the Commission's choice."

Similarly, the Solicitor General stressed the discretionary nature of such Commission actions in opposing certiorari on behalf of the Federal Power Commission in the *Alabama-Tennessee* case (FPC Br. in Opposition in No. 286, Oct. Term, 1966 at pp. 7-8):

> "The question of the appropriate treatment for rate-regulation purposes of tax reductions result-

[29] See, also *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F.2d 567, 573 (5th Cir. 1960), *cert. denied, sub nom., California* v. *F.P.C.*, 366 U.S. 912 (1961).

ing from the use of the liberalized depreciation method is, concededly, a recurring one of general interest and importance in the regulatory community; and the present case represents a change in the thinking of the Federal Power Commission on the subject. Nevertheless, we do not think that the case calls for further review by this Court. The issue of flow-through v. normalization is basically one for resolution through the exercise of administrative discretion. When certiorari was sought in 1961 by the State of California, in the *El Paso* case, to review the Commission's earlier choice of normalization over flow-through, we stated:

> '* * * Such a choice is not one which warrants review by this Court. Under the same principle, the choice is one which can be changed by the Commission should it become convinced the other method is preferable. * * * [*California* v. *Federal Power Commission*, 366 U.S. 912, O.T. 1960, No. 599, Brief in Opposition for Federal Power Commission, pp. 11-12]'."[30]

B. The Changed Circumstances Fully Justified the Commission's Refusal To Require Continuation of Flow Through

In permitting Texas Gas to change from flow-through to normalization with respect to its existing properties, the Commission emphasized that the circumstances had changed drastically, since it had rendered its decision in *Alabama-Tennessee*. Accordingly, it concluded it would not be appropriate to require Texas Gas to remain on flow-through. Such conclusion, we submit, was entirely justified.

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[30] See, also, *City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967) *cert. denied, sub nom. P.S.C. of Wisconsin* v. *F.P.C.*, 390 U.S. 945 (1968); *Midwestern Gas Transmission Co.* v. *F.P.C.*, 388 F.2d 444 (7th Cir. 1968) *cert. denied*, 392 U.S. 928 (1968).

1. A Critical Shortage of Natural Gas Has Developed Since Alabama-Tennessee

As pointed out in its Opinion herein (R. 107), the Commission in *Alabama-Tennessee* had

> "based [its] conclusions on [its] finding that liberalized depreciation would exceed straight-line depreciation where the company continues to make capital additions. Even where the composite plant of a company remains stable, we found, annual liberalized depreciation would not be lower than straight-line depreciation. Thus we concluded that a regulated utility would never be required to pay higher income taxes because of its election to claim liberalized depreciation unless its gross plant declines in dollar value as a result of lower demand or lower plant construction costs."

In so concluding in *Alabama-Tennessee,* the Commission found with respect to gas supply (31 F.P.C. 208 at 218):

> "We do not dispute the contention that economically extractable gas reserves will suffer exhaustion at some indeterminate future date. However, we know of no reliable claim that such exhaustion of gas supplies is certain or even probable within this century. The fact that our gas reserves may be exhausted in the 21st century certainly does not establish that there is a present need for additional normalization."

And with respect to future industry growth and investment in plant, the Commission had stated in *Alabama-Tennessee* (*Id.* at 217-218):

> "Almost all responsible forecasts reflect the widespread belief that the gas pipeline industry will continue to expand at least until 1980 * * * A recent report by the National Fuels and Energy Study group to the Senate Committee on Interior and Insular Affairs, * * * concluded (at p. 37 of

the Report) that the use of gas in 1980 will be somewhat less than doubled the 1960 usage and observed that the majority of the pertinent estimates clustered in the range between 20 and 23 trillion cubic feet. * * * Although these estimates relate to gas consumption rather than to the capacity of gas pipeline plant, it is fair to infer that an approximate doubling of sales will generate a roughly proportional increase in plant investment."

The situation today is dramatically different from that which the Commission envisioned when it issued its opinion in *Alabama-Tennessee*. Referring to the portions of the Commission's decision in *Alabama-Tennessee* quoted above, Mr. W. M. Elmer, Chairman of the Board of Texas Gas and its chief executive officer commented at the hearings in the instant case (R. 4):

> "Today, * * *, the entire industry is faced with a very serious problem relating to the availability of natural gas reserves with respect to the expansion of service as well as service to existing markets. I feel that, with the assistance of the Federal Power Commission in its price fixing policies, the gas shortage problem can be alleviated.
>
> "On the other hand, I am also convinced that the problems involved in acquiring and providing long-term gas supply, on an economical basis, are much more serious today than existed at the time of the Alabama-Tennessee decision."

The natural gas shortage thus adverted to by Mr. Elmer has become even more acute since the close of the administrative record in *Alabama-Tennessee* and has become the subject of widespread public and judicial notice. See, *e.g.*, *F.P.C.* v. *Louisiana Power and Light Co.*, 406 U.S. 621 (1972); *Southern Louisiana Area Rate Cases* v. *F.P.C.*, 428 F.2d 407, 434-444 (5th

Cir. 1970), *cert. denied, sub nom. Municipal Distributors Group* v. *F.P.C.*, 400 U.S. 950 (1970); *City of Chicago* v. *F.P.C.*, 458 F.2d 731 (D.C. Cir., 1971), *cert. denied*, 405 U.S. 1074 (1972); *New York Public Service Commission* v. *F.P.C.*, 467 F.2d 361 (D.C. Cir. 1972). Indeed, in a "Notice of Proposed Policy Statement with Request for Comments" issued in FPC Docket No. R-467, on January 8, 1973, while this brief was being prepared, the Commission undertook to prescribe the establishment of priorities in the use of natural gas because, in part (*mimeo.*, p. 4):

> "Available data indicate that not all jurisdictional pipelines have been able to procure contracts for new supplies of gas in sufficient quantities to insure that all present and potential customers of natural gas will be able to receive an adequate supply in the foreseeable future. Interstate pipelines, in many instances, have been unable to provide additional service to existing customers or service to new customers and some major interstate pipelines are at the present time being forced to curtail deliveries of natural gas below existing contractual commitments.
>
> "Supply shortages may not be eliminated in the immediate future. The recent report on 'National Gas Supply and Demand 1971-1990, Staff Report No. 2', prepared by the Commission's Bureau of Natural Gas projects that the level of potential but unsatisfied demand for gas will rise to 17 trillion cubic feet by 1990. The staff estimates that between 1970 and 1990 accumulated potential demand will exceed projected supplies by more than 185 trillion cubic feet. Additionally, the Future Requirements Committee (FRC) estimates that (exclusive of field use) potential natural gas demand in the United States will increase from about 23.3 trillion cubic feet in 1971 to 28.5 trillion cubic feet in 1975. Based on this projection and on infor-

mation concerning presently contracted or reasonably assured supplies, the FRC estimates that the gap between potential demand and reasonably assured supplies will increase from about 1 trillion cubic feet in 1971 to nearly 4 trillion cubic feet in 1975. *Future Gas Requirements of the United States,* Future Requirements Committee, Vol. No. 4, October 1971, page 3."

2. Texas Gas' Exercise of the Election to Shift to Normalization for Its New Expansion Properties Destroys the Basis for the Commission's Finding That Liberalized Depreciation Results in Tax Savings

In addition to the above dramatic change in the supply picture since the Commission's decision in *Alabama-Tennessee,* the Commission further found that Texas Gas' change to normalization with respect to its new expansion facilities, as permitted under the election, had the effect of rendering tax depreciation on these new facilities no longer available to offset the declining tax depreciation on the older facilities as contemplated in *Alabama-Tennessee.* Accordingly, the Commission concluded—and, we submit, properly so—that the continued use of liberalized depreciation with respect to Texas Gas' older properties would no longer result in tax savings (R. 108).

To be sure, as Memphis urged in the Court below, even with the election, Texas Gas' new productive facilities will still be subject to liberalized depreciation, just as they were before. However, it does not follow therefrom, as Memphis further contended, that the tax depreciation on such facilities will be "available" to Texas Gas to offset the decreasing tax depreciation on the old properties. What Memphis overlooks in making the argument is that under normalization, the difference between the taxes which would be payable under straight-line depreciation and those which are payable under liberalized depreciation is placed in a

specially restricted reserve (Account No. 282).[31] These funds are not available to offset the increasing taxes which are associated with facilities subject to the flow-through method and which result from the declining depreciation deductions as these facilities grow older. The increasing taxes are an expense, and as such, must be offset by income. However, the difference in tax between straight-line depreciation and liberalized depreciation, under normalization, is a charge against income, and therefore, is no longer available to offset the increased tax expenses.

Nor is there any merit to Memphis' argument that, in light of the inflationary spiral, Texas Gas' replacement of existing plant will necessarily reflect a higher investment cost, and thus, that the resulting higher depreciation expense therefor will still mean a tax saving relative to existing and replacement plant even excluding the new expansion facilities. Whatever may be the validity of this argument in the abstract,[32] the argu-

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[31] Under normalization accounting, the difference in taxes on income which are payable because of the use of liberalized depreciation in computing such taxes, as compared to the taxes payable using the depreciation deduction otherwise appropriate and allowable for tax purposes, is credited to Account No. 282 of the Commission's Uniform System of Accounts entitled "Accumulated Deferred Income Taxes—Liberalized Depreciation". Account No. 282 is a reserve for deferred taxes. The utility is restricted in its use of this account. For example, it cannot transfer the balance in the account, or any portion thereof, to surplus or make any use thereof except as specifically provided in the text of the account without prior approval of the Commission. This reserve cannot be used for the payment of dividends or distributed, in any form, to the stockholders, and hence, unlike profits or return, it is not available to the investors.

[32] There is no evidence in the record to support Memphis' position either as to the industry, in general, or with respect to Texas Gas, in particular.

ment does not conform to the facts with regard to Texas Gas. The record shows that, in order to offset the decline in tax depreciation under liberalized depreciation, between 1970 to 1971 Texas Gas would be required to install facilities having a cost of approximately $33,000,000 (R. 17). Based on past experience, there is no possibility of Texas Gas' installing replacement facilities of that magnitude in that period. The plant retirements of Texas Gas for the last fifteen (15) years as reflected in its Annual Reports to the Federal Power Commission (FPC Form No. 2) were:

Year	Annual Plant Retirements	Year	Annual Plant Retirements
1955	$ 981,966	1963	$2,776,415
1956	971,897	1964	1,416,271
1957	1,645,303	1965	1,548,729
1958	1,077,071	1966	1,864,482
1959	927,060	1967	5,262,854
1960	1,169,307	1968	2,652,179
1961	2,026,882	1969	1,937,694
1962	979,429		

Even assuming that all retirements had to be replaced—which is highly unlikely—it is perfectly evident that the amounts expended to replace such property, even at inflated price levels, would fall far short of the $33,000,000 required to offset the loss in tax depreciation between 1970 and 1971.

Finally, contrary to Memphis' claim, no evidence was needed to support the Commission's reference to the fact that the physical life of natural gas properties is much longer than economic tax depreciation life. Since the latter is dependent upon gas supply, it has

long been recognized that the physical life of natural gas transmission facilities far exceeds their economic life. Since at least the Commission decision in *City of Detroit* v. *Panhandle Eastern Pipe Line Co.*, 3 FPC 273, 282 (1942), *affirmed, sub nom, Panhandle Eastern Pipe Line Co.*, v. *F.P.C.*, 143 F.2d 488 (8th Cir., 1944), *affirmed*, 324 U.S. 635 (1944), it has been generally accepted that the economic life of natural gas transmission properties are "governed by such elements of depreciation as the exhaustion of the natural gas supply, wear, decay, inadequacy and obsolescence" and that the provision for depreciation should be "sufficient to provide for the restoration of the capital investment over the life of the gas supply." 3 FPC at 282. See also, *Canadian River Gas Co.*, 3 FPC 32, 46-52 (1942), *affirmed*, 142 F.2d 943 (10th Cir., 1944), *affirmed sub nom Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581 (1945); *Interstate Natural Gas Co.*, 3 FPC 416, 422-425 (1943), *petition for review denied*, 156 F.2d 949 (5th Cir., 1946), *affirmed*, 331 U.S. 682 (1947); *United Fuel Gas Co.*, 12 FPC 251, 265-266 (1953); *Olin Gas Transmission Corp.*, 17 FPC 685, 688-690 (1956); *United Carbon Co.*, 25 FPC 181, 184-186 (1961). Indeed, in accordance with this principle, the Commission has recently permitted United Gas Pipeline Company to increase its 2.88% depreciation rate to 5.00% (*United Gas Pipe Line Co.*, FPC Opinion No. 645, issued January 11, 1973, Mimeo., pp. 10, 11):

> "United has clearly shown * * * that its current reserve life index is substantially below its life index at the time the 2.88% depreciation rates were established. It has also shown that this index has declined sharply since 1948 almost without

interruption. On the basis that the current gas shortage and United's critically low reserve life index will not allow United to expand sales in the future as it has in the past, will probably force it to utilize much of its property at less than its full capacity, and could force it to abandon some of its property prematurely, we find it prudent and in the public interest to allow United to utilize a rate of depreciation which reflects the undeniable change in United's gas supply which has occurred since the currently effective rate of 2.88% was established in 1943."

C. The Commission Findings That Normalization Would Be Beneficial Are Supported by Substantial Evidence

1. The Commission Properly Found That Normalization Would Help Stabilize Rates

As further support for its conclusion, the Commission also found that permitting Texas Gas to change to normalization would help stabilize Texas Gas' rates (R. 109). Contrary to Memphis' argument before the Court below, this finding is supported by substantial evidence.

Texas Gas' witness Meythaler testified, during cross-examination by Memphis' Counsel Morrow, that liberalized depreciation with normalization would provide for stability of rates (R. 34-35):

"Q. I recognize we may be participating in an exercise in futility if the law changes. But by returning to 1966, what you simply mean is going back to the straight-line method of depreciation?

"A. No, I would say we ought to be back to normalization and taking liberalized depreciation, and then we would have a little more chance of stability of rates.

"Q. Yes, because then in that case you would be then taking more tax dollars from your customers than you had to pay to the Government, wouldn't you?

"A. Oh, absolutely. We did not pay the taxes, no. They were deferred taxes, right. And we would have the use of them, correct. And that would give us an ability to maintain more of a semblance of stability of rates than we are faced with today under this practice."

Witness Meythaler also testified at some length with respect to the fact that straight-line depreciation would provide greater stability of rates than flow-through (R. 29-30, Exh. No. 33, R. 46). Exhibit No. 33 and Witness Meythaler's testimony show that, under straight-line depreciation, Texas Gas would have the ability to absorb more than $1,000,000 of increased costs in each of the years 1970 through 1974, or a total of $5,304,000. There would be a similar effect under normalization. In contrast, under liberalized depreciation with flow-through, the company's ability to absorb increased costs each year ranges from $193,000 to $558,000, or only $1,875,000 during the same five year period.

2. The Evidence Shows That Normalization Will Enhance the Quality of Texas Gas' Securities

Similarly supported is the Commission's additional finding in this regard (R. 109) that the use of normalization will improve Texas Gas' before-tax coverage of interest, thereby enhancing the quality of its securities. The revenues from a rate based on normalization are greater than the comparable revenues based on flow-

through by the amount that goes into the reserve in that year under normalization plus the tax thereon. In other words, under normalization, there is included in the rate a dollar for taxes for every dollar that goes into the reserve. Since both the reserve dollar and the tax dollar thus included in the normalization rate are available for the company's before-tax bond coverage, it is apparent that the Commission's finding in this regard is on sound ground.

Memphis sought in the Court below to belittle this finding by arguing that "after-tax" coverage is more important than "before-tax" coverage because taxes have a priority in bankruptcy. But the fact is that since interest is an expense which is payable whether or not there are any earnings and hence it is payable whether or not there is any tax liability, the "before-tax" coverage is patently a matter of primary concern to investors. As summarized by Texas Gas' witness Meythaler (R. 39):

> "Presiding Examiner: The witness' only point is if your interest uses up your income you have no tax. Isn't that—
>
> "Mr. Boland: That's right.
>
> "Presiding Examiner: It is as simple as that, isn't it, Mr. Meythaler?
>
> "The Witness. Yes, sir. It is just a matter of what would you look at from an investor standpoint for protection or ability to pay the interest obligation. And the more dollars you have, the better off you are. And you know that you come in ahead of Uncle Sam, because interest is a deduction."

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals should be reversed with directions to affirm the Commission's Opinions No. 578 and 578-A.

Respectfully submitted,

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APPENDIX A

Pertinent Provisions of Report of House Committee on Ways and Means on Tax Reform Act of 1969, House Report No. 91-413, Part I, 91st Cong., 1st Session

[131] B. DEPRECIATION ALLOWED REGULATED INDUSTRIES

1. Accelerated Depreciation (sec. 451 of the bill and sec. 167 of the code).

Present law.—Under present law, regulated industries are permitted the same elections regarding depreciation of their business properties as are other taxpayers. About half the regulatory agencies re- [132] quire utilities that use accelerated depreciation for tax purposes to "flow through" the resulting reduction in Federal income taxes currently to the utilities' customers. Other agencies permit the utilities they regulate to "normalize" (as described below) the deferred tax liabilities resulting from accelerated depreciation. Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes; even if those utilities use straight line depreciation for tax purposes, such agencies treat them for ratemaking purposes as though they had reduced their Federal income tax expense by using accelerated depreciation.

General reasons for change.—The trend of recent years has been that regulated utilities previously on straight line depreciation have been shifting to various forms of accelerated depreciation. At the same time, regulatory agencies which had previously permitted the tax deferrals resulting from accelerated depreciation to be "normalized" (computing the greater Federal income tax liability that would have resulted from use of straight line depreciation and adding this amount to a reserve account for future tax liability on the regulated utility's books of account), have been shifting toward requiring the flowing through to customers currently of the tax deferrals resulting from the

use of accelerated depreciation. Finally, within the past 12 months several agencies have imputed accelerated depreciation in determining the Federal tax expense of the utilities, and flowed through the resultant tax deferrals, even though the particular utilities involved were in fact using straight line depreciation and in fact were paying the greater current Federal income taxes resulting from the use of that method of depreciation.

In general, flowing through the tax deferral to the customers of a utility that is already earning its maximum permissible profit on its investment, results in a doubling of the Government's loss of revenue from the use of accelerated methods of depreciation for tax purposes. This is because the current tax reduction reduces the rates charged to customers, which in turn reduces the utility's taxable income and therefore reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect. Assuming no other factors become involved, the total loss of taxes may be computed as the initial loss divided by the excess of 100 over the utility's marginal tax rate. At the present surcharge rates, the total tax loss is 212 percent of the initial loss; without the surcharge, the total loss is 192 percent of the initial loss.

Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion; some estimates indicate that the loss might be considerably closer to $2 billion per year. Your committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow through is unacceptable at this time.

Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their

attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.

[133] Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return.

Explanation of provisions.—Your committee's bill provides that, in the case of existing property, the following rules are to apply:

(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.

The taxpayer's present method of depreciation is to be determined by reference to its latest tax return filed before July 22, 1969 (the date your committee's tentative decisions on this subject were published). Property placed in service after the taxable year to which that return relates and before January 1, 1970, will be treated in the same manner as the same kind of property is treated on that return. The taxpayer's present method of treating tax deferrals will be determined by reference to its regulated books of account as of July 22, 1969.

In the case of new property (property completed or acquired after December 31, 1969) the bill provides that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it must stay on accelerated depreciation and flow through unless the regulatory agency permits it to change. In all other cases, accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. (The taxpayer will be permitted to elect straight line depreciation as to such new property and, if the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted to in effect force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes.)

The rules provided by the bill are to apply to property used predominantly in the trade or business of the furnishing or sale of: electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by COMSAT), or transportation of gas, oil (including shale oil), or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency.

Where normalization is used, this bill in no way diminishes whatever power the agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated.

It is expected that regulations will provide for proper allocation of property where more than one agency supervises the activities of a utility, if the several agencies apply different rules to the utility's property.

Effective date.—These amendments apply with respect to taxable years ending after July 22, 1969.

[134] *Revenue effect.*—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979.

APPENDIX B

Pertinent Provisions of Report of Senate Committee on Finance on Tax Reform Act of 1969, Senate Report No. 91-552, 91st Cong., 1st Session

[171] N. DEPRECIATION ALLOWED REGULATED INDUSTRIES

(Sec. 441 of the bill and sec. 167(l) of the code)

Present law.—Regulated industries may make the same elections as other taxpayers regarding depreciation of their business property. About half the regulatory agencies require utilities that use accelerated depreciation to "flow through" the resulting reduction in Federal in- [172] come taxes currently to income. (Where the utility is earning the maximum allowed by law or regulations, this results in flowing through the tax reduction to the utility's current customers.) Other agencies permit the utilities they regulate to "normalize" the deferred tax liabilities resulting from accelerated depreciation. (This involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.) Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, such agencies have treated the utilities they regulate as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight-line depreciation.

General reasons for change.—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this item is unacceptable at this time.

On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

Accordingly, the committee agrees with the House that it is appropriate to in general "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return.

Explanation of provisions.—Both the House bill and the committee amendments provide that if a company (a) is in one of the regulated industries to which the bill applies and (b) at present takes accelerated depreciation and normalizes, or takes straight line depreciation, then the company is not to be permitted to take accelerated depreciation on its tax return unless it normalizes on its regulated books of account for rate-making purposes. Other companies—those that now flow through, as well as those in other regulated industries—are not limited by this general rule of the bill.

Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:

(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must shift to the straight line method unless it continues to normalize as to that property.

[173] (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property.

Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies). In all other cases, accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. The taxpayer is permitted to elect straight line depreciation as to this new property. If the taxpayer seeks to use accelerated depreciation, the regulatory agency may permit it to normalize; if the regulatory agency does not, the taxpayer must use straight line depreciation.

The bill does not change the power of the regulatory agencies in the case of normalization to exclude the normalized tax reduction from the base upon which the agency computes the company's maximum permitted profits.

Both the House bill and the committee amendments provide that the rules set forth above are to apply to property used predominantly in the trade or business of the furnishing or sale of—

(1) Electrical energy;

(2) Water;

(3) Sewage disposal services;

(4) Gas through a local distribution system;

(5) Telephone services; or

(6) Transportation of gas by pipeline.

In all of the above cases the rules of the bill apply if the rates for such furnishing or sale are regulated by a utilities commission or similar agency.

The committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill).

This election applies both as to new and existing property. In order to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, the bill provides that the election will take effect at the start of the company's first taxable year beginning after December 31, 1970. If the books and rates have been conformed to normalization by then, the company may continue to use accelerated depreciation so long as it continues to normalize; if not, the company must use only straight line depreciation. Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency would not be able to impute the use of ac- [174] celerated depreciation with flow-through. In other words, a company that

makes this election would be under the general rule of the bill after its election takes effect.

A number of other changes are also made by the committee amendments.

Oil pipelines are removed from the category of companies covered by the bill and regulated steam producers are included in the categories covered. In addition, Comsat, which was specifically excluded under the House bill, is included in industries covered by the provision.

In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The committee amendments permit such a definition of normalization and do not require that additions be to a separate account described as a "reserve for deferred taxes."

The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.

The committee amendments provide that a taxpayer is not to be treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation deducted on the return is normalized. However, this rule is to be applied for the future only.

Under this rule, differences in the amount of depreciation expense need not be normalized if they result from such differences as (a) use of so-called "guideline lives" for tax purposes and "engineering lives" on the regulated books and (b) different bases for the property because the agency requires that certain carrying charges be capitalized even though for tax purposes they may be deducted or because the agency requires a carryover basis in the case of a purchase of property from another regulated utility even though for tax purposes the basis is what the purchasing company paid for the property.

However, any difference resulting from a faster method of depreciation (including the use of a faster declining balance rate) must be normalized. For example, if a company takes straight line depreciation on its regulated books of account and 200 percent declining balance on its tax return, it does not meet the test of the bill if it normalizes only with respect to the difference between 200 percent declining balance and 150 percent declining balance.

Under the committee amendments, the status of a company as to whether it is on straight line, normalizing, or flow through is to be determined as of August 1, 1969 (instead of July 22, 1969, under the House bill).

Accordingly, the determination of the present method of depreciation generally is to be made by reference to the return for the last taxable year for which a return was filed before August 1, 1969. (It is expected that in most cases this will be the return for calendar [175] 1968). Property not reflected on that last return as public utility property, which is used as public utility property before January 1, 1970, is to be treated the same as property of the same kind or, if there is no property of the same kind, property of the most nearly similar kind that is reflected on that return. If the company's last tax return reflected two methods of depreciation for a kind of property—for example, where it

used straight line depreciation for property put in service through 1964 but used 200 percent declining balance for property put in service since then—the method to be used for property not reflected on the return would be 200 percent declining balance, the method used for the newer property.

Under another provision of the bill (sec. 521, described below), real estate depreciation allowances have been revised, and the most accelerated methods of depreciation (the 200-percent declining balance and sum of the years-digits methods) are no longer permitted with respect to new real estate (other than residential housing); later-acquired used real estate is limited to straight line depreciation. The committee amendments provide that in the case of real estate to which the new limitations on allowable depreciation for regulated utilities apply, that method permitted by the new limitations which is most nearly comparable to the method of depreciation used on the taxpayer's pre-August 1, 1969, return is to be considered to be the taxpayer's present method of depreciation. For example, if the taxpayer used 200 percent declining balance for its new property on its latest tax return filed before August 1, 1969, and in the future acquires new public utility property of the same kind, the 150-percent declining balance method would be its most nearly comparable method.

Under the committee amendments, the status of a company is not necessarily to be determined only by the method of depreciation used on its tax return. Utilities that have used accelerated depreciation (with flow through) in computing their tax expense on their regulated books of account for the latest monthly period ending on or before August 1, 1969, are to be permitted to elect accelerated depreciation (with flow through) for such property and for future acquisitions. In addition, the committee amendments provide that a utility which has filed a request with the Internal Revenue Service for permission to change from

straight line to accelerated depreciation is to be permitted to make that change for such property and for future acquisitions.

Also, if a company adopts flow-through in compliance with a change authorized within 90 days after the date of enactment of the bill by the appropriate State agency pursuant to proceedings instituted by that agency before April 22, 1969 (the date the Treasury Department first made public its recommendations on this subject), during which the company proposed before April 22, 1969, to reduce its rates immediately after being authorized by the State agency to adopt flow-through, then it will be treated as a flow-through company. These provisions are intended to permit companies that have effectively committed themselves to a particular status in their official dealings with the appropriate government agencies to be treated as having attained that committed status.

When the term "straight line depreciation" is used in the above description (and also with regard to the earnings and profits and the real estate depreciation provisions described below) it is intended to encompass also other ratable methods such as units of production and machine hours (but not the so-called "forecast of income" method).

The provision also authorizes the use of regulations to provide for proper application of this provision where more than one agency supervises the activities of a company if the several agencies apply different rules to the company's property, where companies are involved in reorganizations, mergers, or other acquisitions, and in other circumstances in order to carry out the purposes of this provision.

Effective date.—Under the committee amendments, the new rules are to apply to all taxable years for which a return has not been filed before August 1, 1969, even though those years may have ended before that date.

Revenue effect.—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election.

APPENDIX C

Pertinent Provisions of Report of Conference Committee on Tax Reform Act of 1969, House Report No. 91-782, 91st Cong., 1st Session

[312] SUBTITLE E—DEPRECIATION ALLOWED REGULATED INDUSTRIES; EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION

1. Depreciation allowed regulated industries (sec. 167 of the code)

The House bill provides that in the case of certain listed regulated industries (the furnishing or sale of electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services, and transportation of gas by pipeline) a taxpayer is not permitted to use accelerated depreciation unless it "normalizes" the current income tax reduction resulting from the use of such accelerated depreciation. (Normalization involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.)

This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account. Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.

The Senate amendment makes the following changes in the House bill: (*a*) oil pipelines are removed from and steam transporters and distributors and Comsat are added to the categories of utilities to which the provision applies; (*b*) where a company was in the process of changing methods of depreciation or methods of keeping its regulated books of account, the company is treated as having

changed if it had filed a timely request for permission to change before August 1, 1969, or had changed in its regulated books of account for its July 1969 accounting period; (*c*) several technical changes are made to insure that the normalization requirement is not avoided by those to whom the bill applies; (*d*) an election is [313] permitted to be made within 180 days after the date of enactment by a company at present on flowthrough to come under the rules of the bill; and (*e*) a special provision permits a company under specified circumstances to avoid the rules of the bill by changing from normalization to flowthrough.

The conference substitute (sec. 441 of the substitute and sec. 167(l) of the code) follows the Senate amendment except that the special provision referred to in (*e*) above is stricken and the 180-day election (item (*d*), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company.